Major Country Risk Developments
September 2022

By Byron Shoulton

Overview

The global economy is in a state of change and growing uncertainty. Soaring energy prices, high inflation, war tensions, energy and food shortfalls have helped to drive a rise in renewed anxieties hitting policymakers, businesses, and households alike. As the global energy crisis continues to hurt households, businesses, and entire economies worldwide – it appears to some that Russia is winning the energy battle. Russia is undoubtedly a huge energy supplier and the increases in oil and gas prices triggered by its invasion of Ukraine have resulted in an uptick in its energy income for now. But this short-term revenue gain is more than offset by the loss of both trust and markets that is faces for years to come. Moscow is doing itself long-term harm by alienating the EU, its biggest customer by far. Russia's place in the global energy system is changing fundamentally, and in the long run may not be to its advantage.

The group of OPEC+ oil producers agreed to cut crude production for the first time in over a year. They announced a pullback of 100,000 barrels of crude per day amid fears of a global recession and the possibility of more Iranian crude coming to the market - in the event of a revived nuclear agreement with that country.

Concerns over an economic slowdown are dominating global oil markets that have experienced a 25% decline in prices over the past three months. Furthermore, fears of oil shortages following Russia's invasion of Ukraine had driven oil prices above $100 per barrel for months this year, but the market's recent slide prompted OPEC+ to move to prop up a market that had been lifting petrostate economies including Russia, Saudi Arabia, Nigeria, Algeria (among others). The modest production cut will reverse the 100,000 barrels a day that OPEC + announced it would add to the market in July following a meeting between the U.S. and Saudi Arabia (the world's largest oil exporter). The U.S. and the West have urged OPEC+ to pump more oil to help tame rising global inflation, but the group has resisted.

The latest move ended 18-months of production increases for OPEC+. The group slowly brought crude back onto the market after a dramatic cut during the

pandemic when demand plunged. Many OPEC members are currently pumping at full capacity and couldn't increase output even if they wanted to. For example, Nigeria and Angola have been pumping at full capacity but output is below their OPEC-set quotas. The Republic of the Congo, Equatorial Guinea and Algeria have been producing less than they pledged as well. Among OPEC allies, sanctions-hit Russia is also underproducing by 1 million barrels per day, according to the International Energy Agency, which represents energy consumers. Even Saudi Arabia, the world's largest producer – with the ability to ramp output up and down based on market conditions, is nearing its limit, according to oil industry specialists.

Last month, OPEC downgraded its global-economic growth forecast by 0.4% to 3.1% for 2022 due to a weaker-than-expected economy during the second quarter in major economies such as the U.S. The latest production cut came as oil prices were falling closer to $90 per barrel – a level that industry observers regard as a psychological floor that Saudi Arabia doesn't want to see prices fall below. There are also concerns that oil demand could weaken if the global economy enters a recession or if China's Covid-19 restrictions spur further economic slowdown there.

Persian Gulf producers strongly advocated for cutting production after expressing worry about the recent oil-price drop and recession fears. Russia, the biggest non-OPEC producer, had signaled its opposition to a production cut. Moscow is concerned that pulling back would reduce its leverage with oil-consuming nations that are still buying its crude but at big discounts. In the U.S. gasoline prices at the pump are back to somewhat normal levels. Currently, prices are at their lowest since January (weeks before Russia invaded Ukraine and shocked energy markets). Prices have declined about 34% from a post-attack peak hit in early March.

The fall in gasoline prices is important as it could help bolster U.S. consumer spending on other items. However, higher price for groceries, services and numerous other items are a disincentive. Just because U.S. consumers are spending less at the pump than they did in June doesn't necessarily mean that they will redirect more money elsewhere.

In **Kenya** the Supreme Court has dismissed a raft of legal petitions against the results of recent presidential elections (held August 8th); and confirmed that William Ruto is Kenya's new president after a narrow win (50.49% to 48.85%), over five-time challenger, Raila Odinga.

The unanimous verdict by the seven Supreme Court judges, which both camps had agreed to accept beforehand, brings a definitive end to the presidential election dispute, and lifts the cloud of political uncertainty that has been overshadowing the economy. The new president's inauguration will take place on September 13th.

President-elect Ruto's agenda in not clear-cut, despite having served two terms as the deputy of the outgoing president, Uhuru Kenyatta, but major shifts seem unlikely, as most Kenyan politicians and parties support a largely free-market system. In addition, Mr. Ruto will not have unfettered power because of the constraints on his party which does not have a majority in parliament.

The election turnout was relatively low, at 65% (compared with 85% in 2013), signaling a disengagement with politics, especially among younger voters, which is a worrying trend. Also, the outcome suggests that economic factors – such as high unemployment and poverty-are becoming more important than ethnicity in determining voter preferences. Furthermore, Mr. Ruto's win hands power to the next generation of politicians and sidelines the old guard.

Nevertheless, despite the challenges to the election outcome the voting process and the aftermath have been mostly peaceful, helped by the central role of the judiciary, which bodes well for Kenya's institution-

al strengthening. The new president faces myriad economic challenges, led by a large public debt stock and a wide fiscal deficit.

In **Chile,** voters overwhelmingly rejected a newly proposed constitution, with 62% casting their ballots against ratification of the document and 38% in favor. While the rejection was anticipated, the margin of defeat was much larger than expected. Turnout was very high at 86% and the outcome sends a strong message that the draft constitution was far too radical for a majority of Chileans. The expectation is that going forward the next constitutional reform process will result in a more pragmatic document, with a narrower focus.

The sitting Boric administration strongly defended the proposed constitution, arguing that the text's approval was necessary to pass left-leaning reforms. The magnitude of the loss for the pro-reform forces means that the Boric administration will have to shift to the center in order to govern effectively.

The clear winners of the referendum are the centrist and right-leaning parties that successfully campaigned to scuttle the reform, especially the centrist Partido Democrata Cristiano (PDC) and the center-right Chile Vamos (CV). These parties will now feel emboldened to water down Mr. Boric's reforms, including a recently proposed tax reform (and especially the mining royalty increases that it seeks to introduce). The presentation of other reforms, such as pension reform, is likely to be delayed as the government recalibrates amid significant personnel changes and negotiations with a more confident opposition.

This forced shift within the governing left-leaning coalition means that the center-left Socialist Party (SD) will gain significant leverage whereas Mr. Boric's party, the left-wing AD, will lose influence. The president is expected to shuffle his cabinet to give prominent roles to members of the SD, while replacing unpopular left-leaning ministers. President Boric responded to the referendum result by agreeing that Congress would play a more significant role in the next attempt to redraft the constitution.

In the meantime, political and policy uncertainty will weigh heavily on the investment climate, dampening the outlook for the remainder of 2022 and for 2023. Chile remains among the strongest economy in Latin America with a diversified economy combining mining, banking, agricultural, industrial and services sectors.

In **Honduras** the economic agenda of the new president, Xiomara Castro, includes replacing the existing pro-business economic model with a system that prioritizes social spending and state intervention to correct market distortions and which will place pro-market or business-friendly policies on the back burner.

If Ms. Castro's economic model presages a dramatic rollback of pro-business reforms, the already weak business environment and business confidence will be significantly affected, constraining what is expected to be weak growth in 2022-23. On the positive side, the government withdrew some of the initiatives initially feared by the business community and has given assurances that she will not seek to promote some of the more extreme policies pursued in some other left-leaning administrations in Latin

America. Insofar as existing policies toward businesses are respected, a pro-social agenda may even benefit growth further by spurring consumption among Honduras's lowest-income segments. Businesses are advised to partner with industrial lobbies or unions for closer engagement and dialogue with the government.

Europe

The European Central Bank (ECB) increased its main interest rates by 0.75 percentage points due to high consumer-price inflation. The latest inflation figure for August was 9.1% compared with a year earlier – way above the ECB's target of 2%. The central bank said it expects additional rate increases in the future.

Inflation in Europe is not the outcome of a booming economy, but mostly the result of exorbitant energy prices. These are staring to eat so deeply into consumers' pockets and business profitability that the economy is weakening fast on its own, even without the added burden of higher interest rates. After underestimating the threat of inflation over the past year, the central bank must now balance (and not underestimate) against the chances of an economic downturn.

Russia has been weaponizing gas supplies to Europe since the Ukraine war, in response to Western sanctions and their ongoing support for Ukraine. Pressure is building on the EU to launch emergency action to support strategically important economic sectors including energy, metals industry. Businesses across Europe have had to slash production due to soaring energy costs as the crisis deepens for several key industrial sectors including aluminum smelting, steel, manufacturing, etc.

Unprecedented production cuts over the past year are expected to deepen without swift intervention by the EU. Lobby groups have voiced serious concerns about the winter ahead, with a growing consensus that high energy costs could deliver a decisive blow to various industrial operations across the region.

The cost of energy has become far more expensive in Europe than Asia and the U.S. after Russia slashed (and then cut-off completely) gas supplies to the continent. Aluminum smelter production for example, has been cut back (sometimes by 50%) because energy prices have become too high to maintain production. Moreover, there are no signs that any price relief is forthcoming in the near term. Several European aluminum smelters have shutdown (including in Slovakia) and a zinc smelter in the Netherlands.

European metals producers say it is now nearly impossible to sign long-term power supply contracts when current contracts expire – with electricity prices up more than ten-fold over average prices in the previous decade. European aluminum production is running at its lowest in decades. Curtailed production will be replaced with external supplies, underlying the industry's fear that more carbon-intensive imports will fill the void left by European cutbacks.

The IMF has concluded that the EU needs a new fund to help manage downturns in member states and pay for green investments, as it called for an urgent overhaul of the way the bloc handles public finances amid

rising economic hazards. While warning that the EU's current economic framework had failed in its basic task of containing budgetary risks. The IMF said in a policy proposal that the EU needed to create a new fiscal capacity funded by common debt issuance and new income streams, building on the experience of the temporary 800 billion euros Covid-19 recovery funds. Reform of the EU fiscal framework cannot wait, the Fund concluded. Multiple unprecedented shocks on top already high debt levels complicate the conduct of fiscal policy. Interest rates have been rising and monetary policy normalization continues apace. The looming shock to household incomes is likely to spark calls for fresh common EU borrowing to cushion economies – on top of the existing recovery fund.

However, northern EU member states backed the Next Generation EU recovery fund in the teeth of the pandemic-induced slump on the basis that it was one-off instrument, and they have shown little appetite to create a permanent new EU fiscal capacity.

In **France**, it is not expected that consumers will face gas shortages, as direct exposure to Russian gas exports is low, and the country has substantial nuclear power capacity (accounting for 70% of electricity usage) and multiple liquified natural gas (LNG) terminals. This makes France a net energy exporter. However, half of France's nuclear plants are currently offline due to maintenance, with widespread corrosion issues discovered in addition to scheduling downtime.

EDF, France's newly nationalized electricity utility, expects enough plants to be online again by winter to meet the country's needs, but there is a risk that the required repairs will not be completed in time. This would leave a supply gap that would need to be met through imported energy-an expensive prospect given concerns about upcoming shortfall have pushed up prices on the European spot market to record levels.

The potential for technical problems in distributing LNG around Europe, or a breakdown in EU solidarity (with some countries refusing to reduce demand or share gas supplies) could make the situation worse this winter.

The governments are expected to increase support to households and firms, at a further cost to public finances; it could make private sector demand consumption requests mandatory, and in a worst

case scenario it could ration gas to energy-intensive industries and/or place restrictions on household gas use. Government-mandated reductions in energy consumption and very high prices could weigh on economic activity, resulting in some firms becoming unprofitable and going bankrupt, workers being laid-off, loan defaults rising and consumer spending falling.

The EU recession would be deeper. Businesses should be prepared for an economic downturn this winter and attempt to substitute their processes away from gas dependency as soon as possible.

European governments will spend some 50 billion euros this winter on new and expanded fossil fuel infrastructure and supplies, including gas shipped in from overseas and coal to fuel previously mothballed power plants. The EU which previously relied on Russia for about 40% of it gas and more than 50% of its coal, seems to have little choice. Industries from fertilizer manufacturers to zinc smelters have had to shut down, unable to pay the cost of fuel. High energy bills are pushing consumers to the brink. With Russia's complete cut-off of gas supplies to Europe via the critical Nord Stream 1 pipeline, the situation will get worse, pushing Europe one step closer to recession. EU energy ministers will meet on September 9th to discuss a coordinated response to the crisis.

The trade block is now preparing for a bailout to rival the response to the 2008 banking crisis. Recently released figures suggest that EU governments have already allocated 280 billion euros [between September 2021 and July this year] to protect consumers from skyrocketing energy prices, providing cuts to fuel tariffs, paying for gas, and giving handouts to vulnerable households.

Energy companies across Europe are turning to governments to bolster their liquidity and secure supplies. Switzerland's largest renewable electricity producer and the Finish utility have both secured large new state-backed credit lines. Power producers across Europe face acute cash crunch as sharply rising energy prices lead to ballooning collateral requirements on futures exchanges where they hedge their supply contracts.

The Swiss government activated legislation to stabilize the finances of its energy companies at an emergency meeting of the governing Federal Council. Companies have been granted immediate access to a $4.1 billion credit line to help cover trading and collateral costs in the face of soaring prices. Switzerland is particularly vulnerable to turmoil in European energy markets this winter. The wealthy alpine country's dependence on hydroelectricity means it must import 405 of its electricity needs during colder months, when lakes and rivers in the alps freeze.

The EU proposed a levy on non-gas power generators, including renewables, which are benefiting from the high energy prices, as well as to ramp up alternative fossil fuel supplies to prevent citizens from freezing in winter.

Seven floating terminals to process liquified natural gas from non-Russian sources are due to come online in Germany, the Netherlands and between Estonia and Finland in time for winter at a minimum total cost of 3.7 billion euros. Another 19 more are planned across the EU with overall project costs reaching $10 billion (not including outlays for additional infrastructure such as pipelines and jetties). Together these will allow for an additional 30 billion euros in imported gas.

Meanwhile, several countries including Germany and the Netherlands have permitted the restart of operations at coal power stations that had either gone into disuse or were due to close – allowing the burning of an additional 13 million tons of coal costing 4.5 billion euros. Four countries including Germany, the Netherlands, Greece and the Cech Republic have either permitted coal plants to increase production or restarted mining operations. More coal power stations were expected to restart given the demand. However, several operators have been deterred by uncertainty over future pricing and difficulties transporting the fuel up waterways such as the Rhine, which have dropped to unusably low water levels during the summer drought. European energy ministers signed a hastily agreed agreement in July to voluntarily cut gas use by 15% between October and March in an effort to limit additional gas supplies. In France and Spain, rules have been introduced limiting air conditioning in businesses and ordering that advertising signs and shop lights be turned off at night.

EU officials have cautioned that these are only stop-gap measures which will not dent the eurozone's ambition to be climate neutral by 2050. The EU is making efforts to cut energy demand, ranging from limits on heating to turning off public lights at night. The European Parliament is due to vote on proposals to increase is overall goal for renewal energy from 40% of power generation to 45% by 2030.

Some fear that some of the bloc's investments in coal and LNG could yoke it to fossil fuels for longer than planned, putting future emissions targets at risk. Policymakers in Brussels may be underestimating how much "dirty" energy will be needed for more than just the short-term.

The unusual hot and dry summer has worsened the energy outlook. Dried up hydro-electric power resources have resulted in greater demand for gas in countries from Spain and Portugal in the south to Norway in the north. Nuclear power plants in France, already under pressure due to widespread maintenance closers, have been forced to lower capacity due to lack of water to cool the reactors. Plants in Belgium, Switzerland, Germany, and Finland have also been negatively affected.

The EU announced LNG deals with the U.S., Qatar, Azerbaijan, Egypt, and Israel to increase supplies.

Exporting countries are eager to lock in long-term deals suggesting that the EU could be reliant on gas imports for longer than intended. We're in a sellers' market at the moment. Sellers know that the EU is desperate for more reliable LNG supplies.

United Kingdom

The UK currency, the pound hovered at its weakest levels in decades in a sign of faltering investor sentiment - as Liz Truss took the reins as the country's new Prime Minister in early September. The pound fell 8% against the dollar over the summer. trading as low as $1.14. It has not traded at such weak levels since the mid-1980's.

The 10-year UK government bond yield also rose to reach 3% for the first time since 2014. European debt markets have slumped across the board in recent weeks, sending yields soaring, but selling has been particularly acute in the UK gilt market. The new UK government is at a crossroads. Policy announcements over the coming weeks will be key in determining the risk of macro-economic outcome in the UK and the outlook for the pound.

Investors have soured on UK assets over worries that high inflation will force the Bank of England to raise interest rates sharply, which could weigh on the country's longer-term economic prospects.

Core consumer prices in the UK are already rising at the fastest rate across the Group of 10 major economies. The central bank and private bank forecasts point to an economic slump into a recession by year-end. Some expect the pound to slip to a range of $1.05-$1.10, as long-lasting inflation, a worsening growth outlook and the absence of significant household buffers to weather the energy crisis hits the UK. Analysts are focused on the Prime Minister's plans to ease the cost of living that is weighing heavily on consumers and businesses as winter approaches.

The new government will face balancing the need to protect the economy from the effects of the energy crisis and the risks that a major public spending bonanza will worsen the country's fiscal position. That task is further complicated after Russia indefinitely shut-off the flow of gas to Europe. Although Germany and other European countries are morereliant on Russian gas, the internationalized nature of gas markets and the higher rate of inflation in the UK than other European countries, means the UK had been particularly hard hit by the current gas squeeze. Fiscal spending by governments promises to be more inflationary in the UK than the eurozone. Investors in the foreign exchange market are already betting on

further falls for the pound, according to trading in the futures market.

If the new UK government seek to cut taxes or limit households' energy bills it would cost the government tens of billions of dollars which risks worsening the already wide current-account deficit and exacerbate investors' fears about fiscal sustainability.

Centrica, owner of British Gas, is in talks with banks to secure billions of pounds in extra credit facilities.

The new Truss government is now finalizing a 100 billion pounds package to address the UK's energy crisis by capping the cost of gas to bring down bills for households and businesses.

Under the plan the UK government would subsidize the wholesale cost of gas allowing suppliers to cap the price of energy to households and businesses, leaving taxpayers exposed to any further surges in energy markets. Truss's team say the package will provide protection from the biggest energy shock seen in decades, preventing mass corporate casualties, and keeping millions of households out of fuel poverty. It is not clear if caps for households and businesses will be set at the same level.

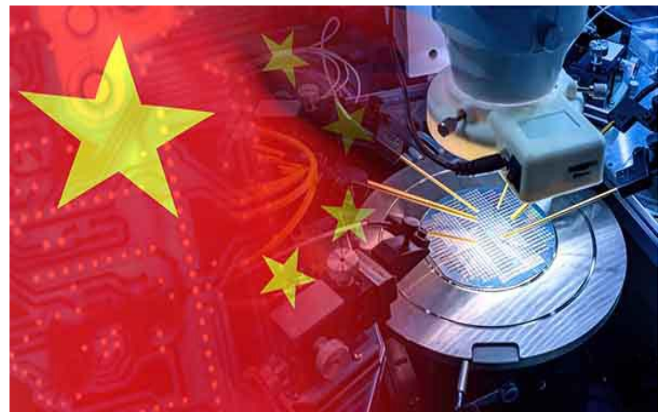
The proposed rescue package will be a huge challenge for the UK'S strained public finances, since PM Truss has also promised tens of billions of pounds in tax cuts. It would be paid back either through consumer bills or taxation over the longer-term.

Capping gas prices would lower wholesale electricity rates. About 40% of the UK'S electricity is generated by gas-fired power plants, which tend to set wholesale rates for the rest of the market, even though other technologies such as wind produce power more cheaply. In the long term, Truss's new government wants to decouple electricity prices from gas entirely, a policy the EU is also pursuing.

China

In a world beset by multiple crises, officials may be looking past the biggest threat of all: China. The country is beset by high debt, covid infections and drought. These belie an economic slowdown that may have been swept under the rug. China remains heavily integrated into the global supply chain and is a potential driver of global demand as one of the biggest markets for foreign goods and services.

Economic news from China has gone from bad to worse. Manufacturing has contracted, retail sales, industrial output and investment all slowed this year and youth unemployment reached nearly 20%. There has been a record outflow of portfolio investments. More than 20% of multinationals are pessimistic about China's five-year business outlook, more than double the percentage last year. The median 2022 GDP forecast was recently cut to 3.5%, in a country that was growing at 6% two years ago.



The pessimism is warranted. While debt is not a new phenomenon, this time its concentrated in the real estate sector, which contributes roughly 20-30% of GDP and accounts for 70% of household wealth., 60% of local government revenues and 40% of bank lending. Home prices in China have fallen for 11 consecutive months, homebuyers are boycotting mortgage payments for unbuilt properties and more than 30 real estate companies have defaulted on international debt.

The policy response has been interest rate cuts and a fiscal stimulus focused on easing liquidity for property developers and boosting funding for infrastructure. This may not do the trick. The money supply expanded but credit slowed sharply, suggesting that China may be stuck in a liquidity trap. Banks are being pushed to lend while demand for loans has plummeted. The fiscal measures to support infrastructure spending are unlikely to offset the slump in the real estate market.

The central government's balance sheet is relatively clean, with a debt-to-GDP ratio of approximately 20%. The government could insist that state-backed institutions lend to property developers and then bail them out, reducing the risk of cascading defaults. But that only postpones the reckoning and creates the kind of moral hazard President Xi wants to avoid.

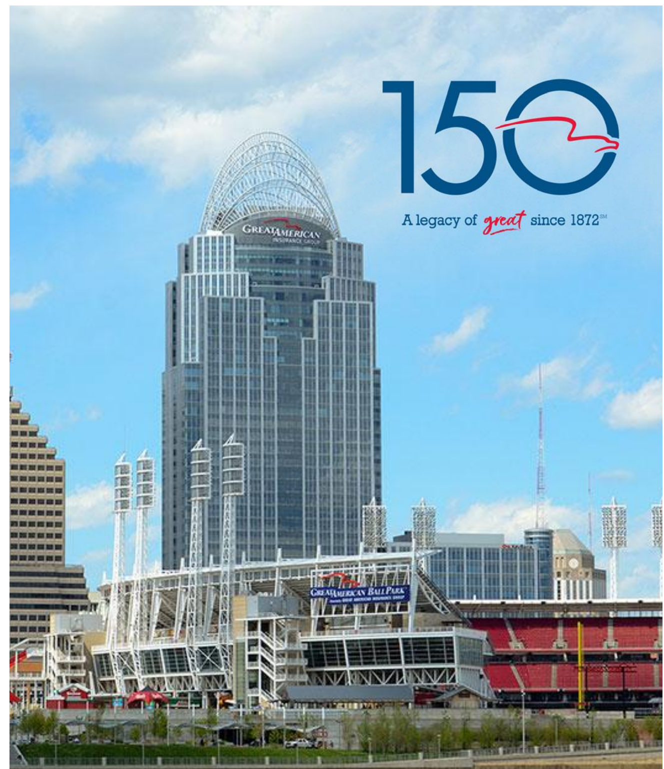
Therefore, China has to drive growth via consumption, rather than through real estate or investment. This will take time and require reducing national savings by establishing a social safety net with subsidies for healthcare, housing, education, and transport.

At the same time, the real estate sector's drag on growth is intertwined with continued rising Covid cases and drought conditions. China continues to pursue a zero Covid policy even as exposure to the virus has expanded to all 31 mainland provinces. Approximately 13% of GDP is currently under some form of lockdown. This has weakened consumer and business confidence, spending, and borrowing- which won't be compensated by mildly lower interest rates. A lack of herd immunity due to less effective Chinese vaccines and relatively lo w immunization rates among the elderly mean a much harder transition to living with Covid.

On top of all this, drought has brought the Yangtze River to its lowest level since records began in 1865. Nearly 90% of China's electricity supply requires extensive water resources and blackouts are causing temporary factory closures, further disrupting domestic and global supply chains. Since six of the areas struck by drought accounted for about half of China's rice output last year, the impact on food supply will be significant.

The stimulus so far rests on credit expansion, delaying the inevitable adjustment and ultimately making it more painful. Droughts may continue to reverberate through the economy as climate events become more common. No one knows for sure if Covid will surge in the winter. All these factors point to a worrying prospect that China could help propel the global economy into a new downturn.

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



Although FCIA has made every effort to insure the accuracy of this publication we do not accept any responsibility whatsoever for - including but not limited to - errors, omissions, opinions or advice given. This publication is not a substitute for professional advice and all information is for guidance only. Coverage descriptions in this brochure are summarized. Consult the policy declarations and policy form for a full description of the applicable terms, conditions, limits and exclusions. Policies are underwritten by Great American Insurance Company, which is an authorized insurer in 50 states and the District of Columbia © Copyright 2022 by FCIA Trade Risk & Political Risk. FCIA logo (letters and design) are registered service marks of Great American Insurance Company. All rights reserved.