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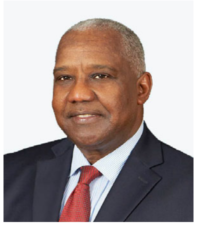
Major Country Risk Developments November 2022



By Byron Shoulton

Overview

Sentiment has shifted toward a global economic slowdown occurring in 2023-2024. The combination of strong inflation and weakening growth presents global policymakers with difficult decisions. High inflation and central banks' response to it - rising interest rates - is having a calming effect on global demand. Higher prices, an energy crisis and increasing borrowing costs have combined to soften consumer demand while weakening business confidence.

Europe is likely to experience a recession in 2023 as it enters a critical phase of its economic conflict with Russia. German factories made the biggest output cuts since the early stages of the pandemic. As Europe's main manufacturing hub and previously one of the biggest users of Russian gas – Germany suffered a sharp fall. Its composite Purchasing Managers' Index (PMI) fell to its lowest level since May 2020, (when large parts of its economy were locked down).

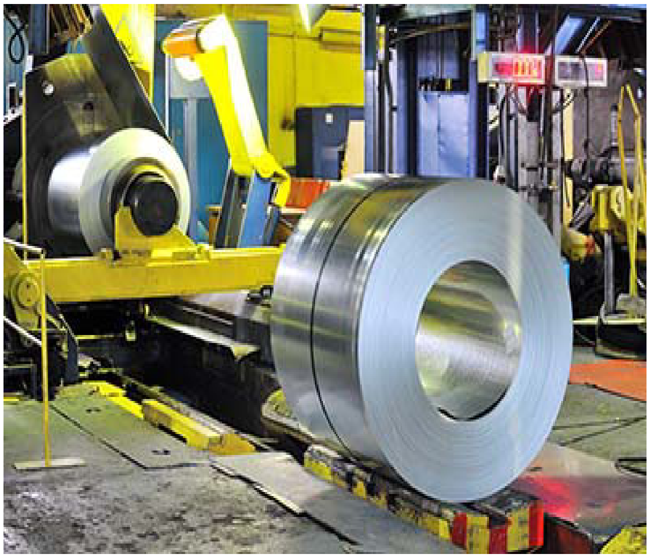
Europe is grappling with the fallout from Russia's decision to withhold energy supplies in response to sanctions over the war in Ukraine. A mild start to the winter heating season and high storage levels have boosted hopes that Europe can make it through the winter without rationing, and has pushed natural-gas prices below $130 a megawatt/hour – from a peak of close to $350 in August. A key near-term risk is further disruption to energy supplies, which, combined with a cold winter, could lead to gas shortages, rationing and deeper economic pain. The IMF has lowered its economic growth forecast for the eurozone in 2023 to just 0.5%.

Both U.S. and European business activity fell in October. A sharp slowdown in services activity, the biggest driver of the U.S. economy, led the U.S. decline. A U.S. recession is likely to follow in the year ahead.

Meanwhile, China's downturn is impacting global output and slowing demand, leading to factory closures, supply delays, shortages, and hefty debt build-ups among governments that are trying to cushion the economic fallout on the most vulnerable, accompanied by an energy crisis and food supply constraints, triggered by the Russian war in Ukraine.

The west continues to confront Russian aggression in Ukraine amidst indifference by some. Meanwhile, Russia forges a close alliance with China, while selling its energy supplies at deep discounts to a ready market (despite sanctions). NATO and its allies have stood the course, so far, in providing material support to Ukraine's heroic fight for survival as a nation state. The economic effect of the conflict reverberates across regions, disrupting vital energy supplies and sparking concerns over food security in many nations. The next twelve to eighteen months will be crucial in how global policymakers, international institutions, the private sector and governments react to help restore order and achieve some sense of economic stability in the global system going forward.

Global trade is likely to slow over the next year [or two] as western economies tip into recession. Overall trade, expected earnings, demand and freight rates are expected to shrink because of declining consumer confidence and consumption. Leading shipping lines expect global container demand – a proxy for trade growth- to contract by 2%-4% this year (compared to previous estimates of 1% growth). This slowdown will extend through 2023 hitting the logistics sector and forcing companies to prepare for idling ships.



Businesses have already responded to the weaker outlook by making fewer overseas investments. The United Nations Conference on Trade and Development says that investments requiring the construction of new facilities were 10% lower in the first nine months of 2022, compared to the same period in 2021. The outlook on global cross-border investments has turned from a strong projected recovery to a downward trajectory. The gloomy prospect is likely to continue into 2023. The decline reflects higher borrowing costs and greater uncertainty.

USA

The Federal Reserve raised interest rates 0.75 percentage points on November 2, 2022 – for the fourth time in a row, lifting the target range to between 3.75%-4%. There is consensus that the Federal Reserve will need to raise rates to 5% early in 2023 – if it is to return inflation to its 2% target, a level many predict will result in a recession and substantial job losses.

New vacancies have appeared among U.S. health employers, food service, transportation and warehousing sectors, helping to fuel a jump in job openings. The data was released as the Federal Reserve gathered for its latest policy meeting. It underscores just how tight the U.S. labor market remains despite efforts undertaken by the Federal Reserve since March – to remove the stimulus it put in place at the onset of the pandemic.

The data suggests the Federal Reserve will need to continue pressing ahead with plans to tighten monetary policy and keep interest rates at a level that restrains activity for an extended period, in order to bring labor demand back into balance with the limited supply of workers.

U.S. mortgage rates rose above 7% for the first time in 20 years, the latest climb that has all but paralyzed the housing market. The rate on a 30-year fixed mortgage averaged 7.08% at the end of October. Just seven weeks prior, the rate was below 6%. A year ago it was 3%. The last time U.S. mortgage rates were this high, the dot-com bubble had recently burst. Rates were on their way down. They were in the middle of a four-decade stretch in which they mostly fell, underpinning the growth of the modern mortgage market and boosting the rate of home ownership.

Interest rates have surged this year pushed by the Federal Reserve's aggressive rate increases meant to curb inflation. The monthly cost of borrowing to buy a home surged because of the additional interest buyers must now pay. This comes on top of a pandemic housing boom that pushed home prices up sharply. The housing market is at the center of the Federal Reserve's effort to curb inflation by jacking up interest rates. In September, existing-home sales fell 24% from a year earlier, and new-home sales were down 18%. Meanwhile, home prices are starting to slip month-over-month. The decline of willing buyers has taken the steam out of what was, a hot housing market.

The S&P Global composite output index for the U.S., which includes services and manufacturing activity, fell to 47.3 in October from 49.5 in September, its second-fastest pace of decline since 2009. An index below 50 signals contracting economic activity while 50 signals growth. U.S. firms reported that the strong dollar and challenging economic conditions in export markets weighed on demand from foreign customers. U.S. firms also reported an acceleration in input cost increases in October, citing higher interest rates, supply shortages and wage pressures. The U.S. economic downturn gathered momentum in October, while confidence in the outlook also deteriorated sharply.

UK

The Bank of England raised interest rates by 0.75 percentage points. The largest such in 30 years. The bank also forecast a long recession ahead for the UK economy.

After years of falling investment in North Sea infrastructure, soaring gas prices are prompting a new wave of interest in gas exploration on the UK's continental shelf.

The producers' interest has been helped by a resurgence in bank lending and by the UK government, which is subsidizing investment – opening the application process for more than 100 exploration and development licenses. Despite important progress in the transition to renewable energy, natural gas remains essential to the UK because of the intermittency of wind and solar power and limited battery storage. Gas is used to heat 85% of homes and generate 40% on the UK's electricity.

While there is some hope that an increase in North Sea production would help protect the UK from the most severe energy price shocks, few expect it to arrest the continental shelf's long-running decline – or to drive down energy costs or prevent blackouts this winter. New fields take two to five years before they can produce, and the gas is sold at prices set by international markets. Amid rampant inflation, war and a deepening energy crisis, it seems the world's climate issues are being overshadowed.

From the North Sea's 1970's heyday until the early 2000's, the UK was able to meet all its own gas demand. But production has declined sharply over the past two decades and the country now imports more than 60% of its needs via pipelines from Norway and the EU, and ships carrying liquefied natural gas from the U.S. and Qatar.

China

The economy grew by 3.4% in the third quarter [compared to 5.5% projected]. The growth outlook has dimmed as price increases, factories closed and Covid restrictions depressed production. President Xi ascended to his third five-year term as paramount leader. He has since replaced all arms of government with loyalists, cementing his complete personal control over the CCC. A secure reinvigorated leadership team is ready to take on the west anew. They stress the goals of order, national security and economic development as being in China's collective interest. The new team under Xi's leadership will choose how to achieve those goals.

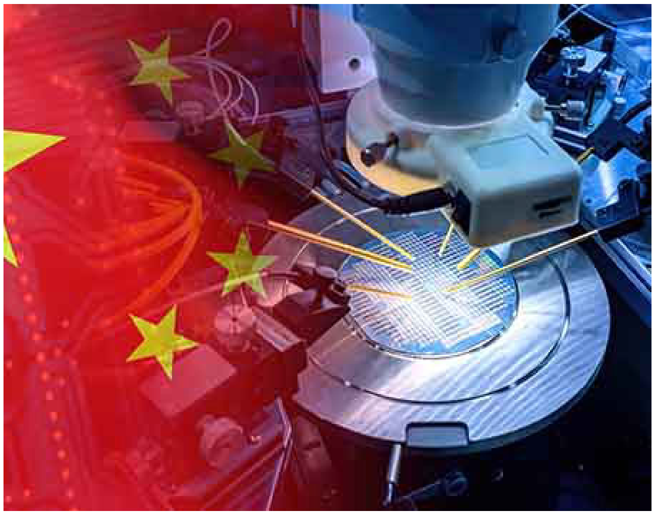
China's close economic integration with the west

[U.S., Europe, Japan, etc.,] and vice versa now stands at center stage. Europe's sudden disconnect from Russian energy supplies has highlighted many countries strong reliance on China for trade: key manufacturing, healthcare, and rare earths – and other essentials for future technological advancements.

For now, it is hard to find much evidence of wholesale western decoupling from China, despite alarm bells regarding over-dependency. China's dominance as the largest producer of manufactured goods grew between 2019-2021. Yet trouble looms. Many high-value technologies, from cloud computing to internet-enabled medical devices, makes little sense in the absence of deep trust between buyers and sellers. National security concerns are intruding. For example, autonomous cars bristle with sensors and cameras. China has banned Tesla from government military sites.

Increasingly, world views collide. Western governments believe they have a duty to protect consumers from buying products from forced labor in a region of China. China seeks to write new rules within which globalization would function going forward. It aims to decrease U.S. influence over the global system. To bend the system to China's and Russia's advantage. China faces ever-louder criticism from liberal democracies. Its leaders see no innocent explanation for surging western suspicion. They see western powers as being blind to China's great achievements and are bent on stigmatizing their country as authoritarian. This view is shared by many of Chinese intelligentsia , who once admired the west. They now see the west for too long a rulemaking hegemon, which now stands exposed as hypocritical. They say China is fully integrated into the world economy. They do not expect China to follow Russia down a path of autarky and confrontation with the west.

Chinese officials are stepping up a campaign to reassure international investors of China's economic strength as it battles a property sector crisis and flagging growth induced by its strict zero-Covid policy. State-run Chinese media have pushed a narrative of economic resilience and recovery coming out of the Communist Party's 20th congress where President Xi secured an unprecedented third term as leader.



The consensus is that China's economic outlook has been deteriorating due to Xi's strict zero-Covid policy which has meant lockdowns across large swaths of the country. The leadership has advanced the theory that future growth will be slower. Export growth has already dialed back partly because of Covid restrictions. China wants future growth to be determined more on domestic demand and be less driven by exports. This would protect against any likely decline in western business/investments with China. Also, it signals a change and serves as a safeguard against China becoming overly dependent on exports for growth in years to come. Many among China's elite see a U.S. plot to keep China down. They perceive the U.S. and the west as being unprepared to deal with a China that is different, strong, and rising fast. They point to panic, followed by overreaction on the part of the west to China ascendency. The relationships with western companies and governments could become intense depending on how the renewed Xi leadership decides to proceed: confrontational or with room for engagement.

Global tensions have highlighted risks associated with China trade as well as an uncertain outlook surrounding future western investments in the country. Concerns have grown over risks that could arise while doing business in and with China. Transactions now require greater scrutiny [on both sides]; tariffs, security concerns have also heightened. China's bilateral relationships are becoming more complex, are fraught with mistrust and are more stressful for all concerned. This is true of China's relationship with the U.S., Germany, the EU, and other trading partners globally. Nonetheless, China remains a major trading nation, manufacturer, a leading creditor nation, with loans extended globally; and numerous infrastructure projects undertaken [including roads, ports, waterways, railways, mining, etc.,] in all regions.

Wealthy Chinese are reportedly pulling the trigger on exit plans from their homeland as pessimism builds over the future of the world's second-largest economy under President Xi and the ruling Chinese Communist Party. The wealthy appear worried about rumors of an official wealth tax that would replace informal "common prosperity" donations. Some are said to be increasingly concerned for personal safety, even once they have left China. Those concerns have deepened following a series of temporary or longer-term disappearances of high-profile people from public view over recent years.

Increasingly, some Chinese leaders have stressed the urgency of the resolving the Taiwan question. One school of thought: China's People's Liberation Army considers now a good time to move against Taiwan and prevail. The west it says, is distracted, spread thin on many fronts and unprepared for protracted military engagement over Taiwan at this time. An anti-secession law passed in 2005, states that China's rulers must not let Taiwan drift away until it becomes irrecoverable. Chinese hawks call for early military action. Others make clear that time is on China's side.

Besides, China is assured Russian support in any undertaking to reunify the mainland with Taiwan.

Some in China point to Russia which has yet to be broken by sanctions imposed after the invasion of Ukraine. They remind the west: you have already lost Russia; can you afford to lose China too?

In recent polls only 6.4% of Taiwanese people say they want to be ruled by Beijing now or in the future. However, there is no reason to think that Chinese officials are bluffing about crushing Taiwan's hope for freedom. There is contempt for such freedoms. Chinese officials call foreign admiration of Taiwan's democracy a "smokescreen." China's obsession with control is eliminating any painless routes to peace. For over 77 years Taiwan's fate has been integral to the Asian security order. Its liberal political order is also at stake. China's stance on Taiwan has hardened. U.S. bipartisan support for Taiwan is at its strongest.

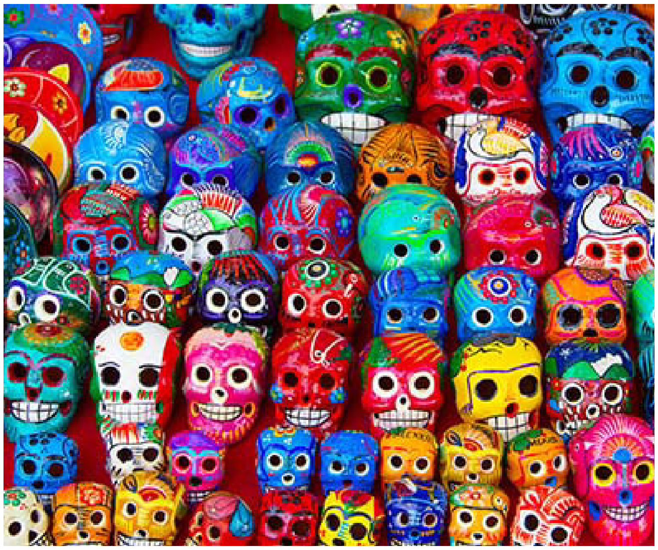
Hong Kong is seeking to boost its status as an international financial center, after a clampdown on civil society and years of strict pandemic restrictions. These restrictions triggered an exodus and raised concerns the city was losing business to rival Asian hub Singapore.

Latin America

Growth momentum continues in the region with expected GDP growth of 3.5% in 2022. Amid tightening global financial conditions, however, growth is projected to decelerate to 1.7% in 2023. Regional inflation is the highest in two decades and is expected to recede only gradually - helped by decisive action by the region's central banks.

The IMF insists that monetary policy in Latin America should stay the course, and avoid easing prematurely, while suggesting that fiscal policy should focus on strengthening public finances, and protecting the most vulnerable from the inflation shock.

After contracting sharply in 2020, most of the economies in Latin America and the Caribbean experienced some recovery in 2021 and early 2022, aided by an uptick in global momentum, the normalization of service sectors, favorable external conditions, including strong commodity prices. Strong momentum early in 2022 led to an upward revision of growth to 3.5% for 2022 – half a percentage point higher than was projected last July.



However, inflation pressures have grown and is now broad-based across the region. In Brazil, Chile, Colombia, Mexico and Peru inflation hit a two-decade high of 10.1%. The swift response on the region's monetary authorities – raising interest rates well ahead of other economies- has helped contain price pressures and should keep long-term inflation expectations anchored. However, inflation remains high and is expected to recede only gradually over the next two years.

Amid global monetary and financial tightening, the ensuing slowdown in global growth and softening of commodity prices, growth in the region is poised to slow to 1.7% in 2023 or 0.3 percentage points lower than forecasted in July. Downside risks dominate the outlook and stem from tighter financial conditions, a more pronounced global slowdown, and entrenched inflation. The possibility of a sharp fall in commodity prices and social unrest are also important risks for the region.

According to the IMF, with inflation yet to abate and most economies still operating at or near potential, monetary policy should avoid easing prematurely and should instead stay the course.

Having to restore price stability later down the road – if inflation becomes entrenched, would be very costly. With weak public finances in many countries and rising financing costs, strengthening fiscal frameworks with particular emphasis on inclusive policies, will be key to credibly put public debt on a downward path while ensuring social stability.

Achieving these policy objectives will also require boosting medium-term growth, by raising productivity and good-quality public and private investment. Policies will need to focus on strengthening human capital across the region, simplifying and modernizing labor regulations, and lifting barriers to firms entering and exiting the region.

Chile

The consensus is that Chile's economy will be buffeted in 2023 by an adverse domestic outlook. There's uncertainty related to the country's constitutional reform process and the scope of the left-wing reform agenda of the sitting government of President Gabriel Boric.

The recent rejection of the proposed constitution will extend policy uncertainty well into 2023 and the rewriting of a new set of proposals will delay investment decisions. The is weighing on investor sentiment and will likely lead to a decline in investment inflows. The Boric administration's ambitious agenda, tax reforms and expanded environmental, labor and social regulations, will hit business confidence. The risk is that policies passed by the Boric government will become harmful to Chile's business environment. This would cause new investment to fall even lower.

Meanwhile inflation rose to 13.7% in the third quarter and interest rates have also risen.

The Chilean private sector [including foreign firms, mining and related companies] are bracing for possible huge tax increases and stricter regulations related to labor, environmental and social issues – which will increase obsticles to doing business. These reforms – if passed- would also raise the operating costs considerably in order to function as a business in Chile. Firms have been advised to devise strategies to address greater than expected tax increases and other possible rigidities that may be forth coming under the current administration.

Until recently, Chile has been one of Latin America's strongest democracies, with an independent judiciary and central bank, the rule of law and sound economic policies. Despite an impressive track record of economic growth leading to a reduction in poverty since 1990, social unrest of late 2019 underscored widespread frustration with the political system.

However, since President Boric's election in 2021 public opinion has grown more skeptical of many of the proposed constitutional reforms, hence its defeat in the referendum. The unpopular Boric left-wing agenda will struggle to pass in an evenly divided congress. The fear is that the passing of many of the Boric constitutional reforms will be harmful to the business environment and would shift economic performance to slow growth, high social spending, and would eventually depress the country's standard of living.

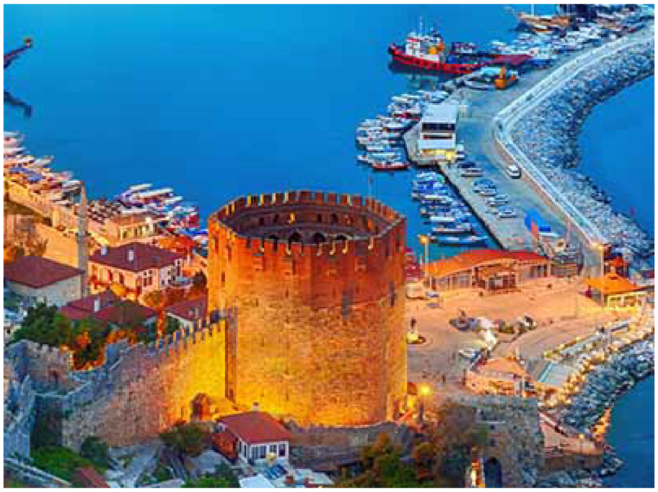
Turkey

As western governments raise concerns that Turkey is serving as a backdoor for Russia to evade sanctions [imposed over the war in Ukraine], Turkey has responded that its ties with Russia are merely "good neighborly relations".

A steady and hefty flow of Russian cash has made its way into Turkey since the Ukraine war. These are mostly the result of Russians fleeing Russia and others getting their money out of Russia. Turkey, a NATO member that shares a Black Sea border with Russia and Ukraine, is, wittingly or not, relieving financial pressure on Moscow by not participating in western sanctions. Turkey points out that its economic ties with Russia are legal.

The Turkish economy relies heavily on inflows of foreign capital. The country is under heavy strain from high commodity prices, a soaring U.S. dollar and unorthodox monetary and fiscal policies that have sent traditional investors fleeing Turkey – one of the world's biggest emerging markets. The Turkish finance ministry is under pressure to shed light on the mystery funds from Russia that have played a key role in financing Turkey's large current account deficit – caused by an import bill that exceeds the value of the country's exports.

According to the Turkish central bank net financial inflows categorized as "net errors and omissions" – money whose origins is unclear – reached a record $28 billion in the first eight months of 2022. Those inflows have financed around 70% of Turkey's $40 billion current account deficit during the same period. This remains a point of contention among western governments.



The Turkish finance minister says that unaccounted for tourism revenues were a key component of these inflows. Some came from Russians, many of whom used cash because they were unable to use the financial system owing to western sanctions on Moscow. Russians were Turkey's second-largest group of foreign visitors this year.

The Turkish explanation goes further. They argue that Turkey is surrounded by war: in Russia, Syria, Iraq. According to this narrative, Turkish companies and individuals have repatriated money that was kept offshore back to the country – a movement that Turkish authorities insist was also sometimes cash-based. All the inflows of funds were legitimate claims Turkey's finance ministry, despite western concerns that using cash makes it impossible to track the true origins of funds.

The Turkish authorities anticipate that the streak of cash inflows would continue and voiced confidence that Turkey would comfortably avoid a balance of payments crisis over the next year despite the $100 billion energy import bill the country faces.

Turkey is pushing hard for a discount on the vast quantity of gas it buys from Russia – which would ease pressure on the Turkish lira and bolster President Erdogan's stature ahead of crucial elections scheduled for summer 2023. Turkey is also asking Russia's Gasprom for an option to delay payment. They are expecting a positive response on both fronts.

Turkey has also confirmed that money has been transferred by Russia's state nuclear agency for the building of an atomic power plant on the country's southern coast – a move that analysts speculate boosted the Turkish central bank's foreign currency reserves by an estimated $5 billion-$10 billion. The true sum was not disclosed.

The central bank cut interest rates for a third month in a row – even as inflation exceeded 83%. President Erdogan rejects the established economic principle that raising interest rates curbs inflation, has presided over a succession of currency crises and bouts of ultra-high inflation as he insists on reducing borrowing costs to promote growth. The Turkish president argues that he is pursuing a new economic model that will capitalize on the weak lira -which has lost about 50% of its value in 12 months- to boost domestic production, create jobs and boost exports. However, the turbulent currency has triggered a sharp fall in Turkish prosperity, with GDP per capita falling from a peak of $12,500 in 2013 to roughly $9,500 in 2021. The authorities admit that many Turkish citizens are going through a painful period and that the government was seeking to limit the pain via social transfers, including two minimum wage increases during 2022.

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