Major Country Risk Developments December 2022

By Byron Shoulton

Overview

Faced with mounting opposition to strict Covid lockdowns and anti-government protests not seen in a generation, plus its lowest growth targets in three decades – China's leadership confronts an unexpected threat of social unrest. The authorities have reacted swiftly by easing daily testing requirements in some major cities, while instructing local governments to become more sensitive and flexible in the implementation of lockdown directives. The Chinese Communist Party (CCP) has historically been especially unaccepting of social instability in this one-party dominated system. The effects of the lockdowns on production, employment, lack of mobility; and communities feeling cut-off from access to everyday conveniences, has created deep frustrations among the Chinese populous.

For the recently 'crowned' three-term President Xi Jinping, the recent outbursts of unrest, coming so soon in the beginning of his new term – represents an unwelcome blot on his record. Street demonstrations, and defiance toward authority on display by young unemployed Chinese citizens, also reflects poorly on the CCP's renewed dominance over all aspects of civilian and political life under president Xi. With these developments and the specter of global eyes focused on instability in China, the need to get the economy moving again takes on greater urgency. President Xi could be facing the biggest test of his tenure.

The outcome could reshape how foreign multinationals operate in China, the flow of global manufacturing investment, and China's relations with developed democracies. For decades, foreign companies operating in China have benefited from access to the country's massive labor force, in exchange for largely steering clear of politics. Investment- hungry local Chinese governments, in turn, have often acted pre-emptively to defuse problems that might complicate business- particularly independent labor activism, resistance to land acquisition, or other forms of organized protest. That has been one key factor that has long distinguished China from other potential manufacturing competitors such as India. To the extent that multinational manufacturing worried about political risks, it has primarily been about geopolitics, rather than conditions in China itself.

The recent protests erupting over Covid policies and labor conditions, represent a serious challenge to two key assumptions underlying this arrangement. First, that companies can count on a fundamental level of political stability when they invest in China. Second, that workers will not push labor actions too far for fear of state reprisals. However, violent protests against unpaid bonuses and harsh lockdown conditions that erupted in Apple supplier Foxconn's factory in November were notable for their scale, ferocity, and the fact that they occurred at a major multinational factory. They also resulted in a clear victory for workers, who received guarantees their contracts would be honored and the option to quit with a 10,000 yuan, equivalent to $1,400 payment. Recent developments are likely to further accelerate manufacturers' plans to diversify away from China, even if it represents the beginning of the end for China's zero-covid commitment.

Separately, the potential unraveling of the 'old order' in the global oil market is at a defining moment as Europe starts to block Russian seaborne crude from the continent. This marks one of the strongest

responses yet to Russia's invasion of Ukraine. The new EU sanctions will stop European companies from insuring vessels carrying Russian oil to third countries – unless those countries accept a price for the crude dictated by the west. In other words, western countries are attempting to impose a cap on the price of oil sold by Russia. It remains uncertain how disruptive these measures will be. Sanctions imposed on Russia since its invasion of Ukraine on February 24 have barely dented Russian oil exports or the Kremlin's oil income. However, the principle that Moscow's geopolitical foes set the price at which Russia sells its crude is a humiliation for a petrostate that produces more than 10% of the world's oil and sits alongside Saudi Arabia at the top of the OPEC+ cartel.

At the same time, Saudi Arabia and other OPEC oil producers discussed an output increase but decided against any change, for now. A production increase would have helped to heal OPEC+'s rift with the U.S. and keep energy supplies flowing amid attempts to blunt Russia's oil industry over the Ukraine war. Any output increase would have marked a partial reversal of the controversial decision by OPEC+ in October to cut production by two million barrels per day. That decision, to cut production, undermined global efforts to blunt Russia's war in Ukraine. It was also viewed as a political slap in the face to the U.S., coming at a time of high inflation and just before the U.S. congressional midterm elections. The U.S.-Saudi relations hit a low point as a result.

Talk of a production increase has emerged at an unusual time, with global oil prices falling more than 10% in November. A production increase in response to expectations that oil consumption will rise in the winter, as it normally does would have reduced price pressures. Oil demand is projected to increase by 1.69 million barrels a day to 101.3 million barrels a day during the first quarter of 2023, compared with the average level in 2022.

OPEC and its allies have been carefully studying the Group of Seven industrialized countries [G-7] price cap on Russian oil, conceding that the move by crude consuming countries to control the market is a threat. Russia says it will refuse to sell oil to any country participating in the price cap. That act would potentially result in another effective production cut from Moscow [one of the world's top three global oil producers]. Saudi Arabia, on the other hand has affirmed that it would "supply oil to all who need it from us." Oil producers are signaling to western countries that they would step up if Russian output fell short.

Talk of a production increase sets up a potential strain between OPEC+'s two heavyweight producers, Saudi Arabia and Russia. The countries have an oil- production alliance that industry officials in both countries consider a marriage of convenience, and they have clashed before. Saudi officials have been adamant that their decision to cut production in October was not designed to support Russia's war in Ukraine. Instead, they say, the cut was intended to get ahead of flagging demand for oil caused by a global economy showing signs of slowing down.

Another factor driving discussion around rising output: two big OPEC members, Iraq and the United

Arab Emirates, want to pump more oil. Both countries are pushing the cartel to allow them a higher daily-production ceiling, a change that if granted, would mean more oil production. Any misgivings inside OPEC is a first sign that the UAE, Iraq, among others, is adopting a new strategy: sell as much crude as possible before demand dries up.

Brent, the international benchmark for crude, has fallen from $120 per barrel in June to around $85 today as oil traders zero in on signs of global recession. China's commitment to a "zero-covid policy has crimped demand and provided a release valve of sorts for wider pressures in the market. However, China is being pressured to relax restrictions which will mean the China economy will eventually see a pick-up in demand for oil in another six months.

European natural gas prices have fallen from peaks close to $500 per barrel equivalent this summer, after Russia moved to almost completely sever supplies. However, gas is still trading at about five times the historical norms, wreaking havoc on economies and stoking inflation globally. If China were to ease Covid restrictions (a distinct possibility given widespread street demonstrations against the lockdowns), its demand for oil and imported liquefied natural gas, which Europe is now heavily reliant on, could soar. There are no sanctions on Russian gas, owing to its importance to some European nations' energy security. The Kremlin has taken advantage by gradually reducing the flow through pipelines after the invasion of Ukraine, boosting prices and fueling a cost-of-living crisis across Europe.

In addition to releasing unprecedented volumes of oil from the U.S. emergency stockpile, the price cap on Russian oil, first promoted by the U.S. Treasury and reluctantly embraced by the European Union, is currently the most important, controversial and keenly watched initiative. The plan is designed to offset much tougher restrictions put in place under EU sanctions on Russia. The G7 nations endorsed the U.S. Treasury's plan, and the EU has incorporated it into a new set of sanctions against Russia's ongoing aggression in Ukraine.

Meanwhile, OPEC Gulf states, including Saudi Arabia

and UAE, are carefully maneuvering around the impression that they are siding with Russia in the Ukraine conflict. Instead, these countries point to the need to manage a turbulent oil and gas market which remains the lifeblood of the global economy. Privately, they chafe against the price cap placed on Russian oil, believing that similar sanctions could one day be turned against them. They also point to what they see as hypocrisy of the west: demanding higher production while also seeking lower prices, which the industry argues has stymied investment and left the market ill-prepared for this crisis and what might come next.

The U.S. eased sanctions against Venezuela and granted Chevron a license to resume pumping Venezuelan crude. The intent is to help balance the loss of Russian supplies over the medium-term with renewed production from Venezuela. Most of the renewed Venezuelan crude production would probably be shipped to the U.S. Venezuela is home to the largest oil reserves in the world, slightly larger than Saudi Arabia. The once prosperous OPEC nation's hyper-inflationary collapse has led to more than three-quarters of its population living below the poverty line. A record number of Venezuelans are turning up at the U.S.-Mexico border. Substantial investments are needed to achieve significantly higher Venezuelan oil production. Confidence among oil producers that would make them willing and comfortable operating in Venezuela remains questionable. Ongoing political tensions with the U.S. and uncertainties over potential government intervention, represent significant obstacles to new foreign investment in the Venezuelan oil sector.

Russia's economy contracted for the second quarter in a row as the western response to the invasion of Ukraine helped plunge the economy into recession. GDP fell 4% year-on-year in the three months to October, according to preliminary date released by Russia's statistics service.

The contraction follows sweeping restrictions from the U.S. and Europe on Russia's energy and financial sectors, including a block on half of the central bank's $640 billion foreign exchange reserves. About 1,000 western companies followed suit, curtailing their Russian operations, while hundreds of thousands of people reportedly left the country after President Putin mobilized the army's reserves in September. This was the second consecutive quarterly fall after the Russian economy fell 4.1% in the previous quarter. However, it was better than the 7% contraction forecast by the central bank. Higher energy prices have helped boost Russian budget revenue, half of which comes from oil and gas.

The fall in output marks the second Russian recession in three years. The economy contracted throughout 2020, during the pandemic. It is also the third largest downturn in 20 years after the international financial crisis in 2009 and the pandemic.

Russia's economy has also been hard hit by higher interest rates. Inflation, which reached 13.7% in November, is now expected to slow to between 5-7% in 2023. The central bank expects the factors pushing up prices to be outweighed by a dampening of consumer demand due to a "rise in overall uncertainty."

In Ghana, following a decade-long borrowing spree the country is now on the brink of default. Ghana owes around $50 billion in total, $14 billion of which is denominated in foreign currencies. There is a $1 billion bond which falls due in 2030. That bond was issued in 2015. Unlike other Ghanaian Eurobonds, this one is backed by a World Bank guarantee of 40% of its face value.

Recently, the government suggested that sovereign bondholders could be asked to take a 30% “haircut” on their investments. Ghana is unlike recent defaulters such as Zambia and Sri Lanka, where years of government profligacy and mismanagement brought fiscal problems to the brink of crisis before the pandemic tipped them over the edge.

Ghana benefits from a healthy mix of commodity exports- gold, cocoa and oil-and a history of tackling fiscal problems before they got out of hand. In July, Ghana asked for, what would be, its 17th package of support from the IMF. Its most recent ended in April 2019.

The policy reforms implemented then were unable to withstand the shock of Covid-19 and subsequent global crises. The government spent heavily, both on its pandemic response and on a successful re-election bid. Since then, its fiscal woes have deepened. Debt service absorbed 54% of government revenues in the first half of this year. Local bond yields peaked above 50% in November, from 21% in March. Yet government officials appear to be in denial. They announced plans to sell foreign debt this year when rising interest rates meant markets were already closed. In November, President Nana Akufo-Addo promised creditors there would be no haircut.

It is now inevitable that a new IMF program will be needed. The risks are priced in: yields on Ghana’s sovereign bonds barely budged from their already highly stressed levels. A $1.2 billion bond maturing in 2032 with an 8.125% coupon at present yields about 30%.Ghana’s currency has been one of the world’s worst performing against the dollar this year, inflation is at a 21-year high of 40 per cent and debt servicing is expected to take up 47 per cent of revenue in 2022, a reversal of fortune for a country once hailed as an economic success. Ghana’s president has faced a string of protests demanding his resignation.

While Ghana's economy expanded at an average 6 per cent gross domestic product growth annually between 2000 and 2019, this year — battered by the Covid-19 pandemic and the fallout of Russia's invasion of Ukraine — it is forecast to grow by 3.5 per cent. Although Akufo-Addo insists it can still meet its debt repayments, it has started talks with the IMF to receive a $3 billion loan.

Brazil

On January 1, 2023, Luiz Inacio Lula da Silva (aka Lula) will return as Brazil's president. Political power shifts in 2023 will come not just from Lula's historic return to power, but also from a substantial shake-up in Brazil's congressional, local and regional elections. The expectation of a slowdown in the global and U.S. economies in 2023, elevated domestic interest rates and still-high inflation will cause GDP growth to weaken from an estimated 2.7% in 2022 to 0.7% in 2023.

The economic slowdown will be aggravated by deteriorating credit conditions as loan costs increase, credit growth weakens, and delinquency rates are expected to rise in the new year. These factors will limit household consumption and potentially limit export volume growth. Furthermore, the expectation of a deterioration in Brazil's fiscal dynamics will constrain government spending in 2023.

President-elect Lula's foreign policy ambitions will be tempered by geo-political circumstances over which Brazil has little control. Many expect that with his return Lula will be able to repeat the kind of globalization and activist global policies that worked well for Brazil between 2003-2010 during his previous stint as president. However, the world has changed since then. Current negative trends on growth will be partially offset by an expected modest recovery in private investment with the change of government.

Under outgoing president Jair Bolsonaro, Brazil retreated from its previous role as a leading emerging market. Bolsonaro's foreign friendships became limited. Under Bolsonaro, Brazil led an enthusiastic assault on the Amazon rainforest in the name of development and sovereignty, which tarnished Brazil's reputation as a responsible global leader in the struggle against climate change.

Lula's brand of foreign policy practiced during his past tenure had as its cornerstone the search for a "multipolar" world at a time when the U.S. was considered hegemonic. China became Brazil's biggest trading partner during Lula's first tenure, a fact that many in Brazil's private sector recall with mixed feelings. Cheap Chinese imports undermined Brazil's domestic manufacturing industry while Brazil's agri-businesses expanded to historic highs, and agricultural exports to China tripled. In today's world of geopolitical confrontations including war in Europe, Brazil's traditional balancing act between east and west, north and south, has become harder. BRIC nations remain important in economic terms. Brazil condemns Russia's invasion of Ukraine, but like many developing countries, will not cut ties with Russia. While Lula will remain friendly with China, his team worry that trade between the two countries will continue to undermine Brazilian industry.

Another shift is climate change which is now a bigger global issue. That plays to one of Lula's strengths. His pledge to crack down on deforestation of the Amazon will be welcomed by forces in the U.S. and Europe. Incoming Lula government may try to reactivate the Amazon Pact, a treaty of 1978 which links Brazil and seven other countries that share the rainforest. Deforestation was a pretext for the EU's refusal to ratify a trade agreement with Mercosur countries concluded in 2019 after 20 years of talks. Lula may press ahead, but wants tweaks, and that will be welcome in the EU. Meanwhile, Mercosur is itself weaker than it used to be. Uruguay's [a key Mercosur member] center-right government is increasingly going its own way on trade.

Lula's victory is also noteworthy in that regional

left-wing governments are in charge in all of Latin America's bigger economies. However, there are many differences among them.

Lula's Latin American policy while he was previously president, was underwritten by cheap credit from the national development bank, much of it tried to domestic and global construction contracts. All this has disappeared in the past decade. Lula will lead a weaker government facing fiscal constraints in a deeply divided country. This is likely to limit how much energy and political capital he can devote to foreign policy.

Although outgoing president, Jair Bolsonaro of the Partido Liberal was defeated, there were notable wins for "bolsonarista" candidates, not only in congress, but also in some of Brazil's most populous and economically important states. Given the need for pragmatism if the president-elect is to govern effectively; and the fact that states are dependent of the federal government's largess – both sides will be forced to cooperate with each another in the years ahead. However, their honeymoon may not last beyond the halfway point of Lula's term, when political actors will start to focus on the 2026 presidential election. The relationship between the federal and state governments is central because the president needs the state governors, who hold influence over legislators from their states to enact reforms. Although governors have some of their own revenues raising resources, they still rely on the federal government for funds. In addition, federal laws can directly influence the administration of states.

For Lula, the challenge of navigating this relationship has been made more difficult by the results of this year's state elections. The outcome reflects a polarized political landscape and an increase in support for Bolsonaro and his allies: 11 of Lula's allies were elected

governor [mostly in the poorest northeast region. Compare that with 14 of Bolsonaro's allies elected [mostly in country's more developed areas]. Candidates allied with Bolsonaro won in the three most populous and developed states in the Southeast – Sao Paulo, Rio de Janeiro, and Minas Gerais; and in two of three conservative states.

In the country's soybean belt, Bolsonaro's allies claimed victories across the board; and "bolsonaristas" won five seats in the Amazon. Overall, the performance of Bolsonaro's allies showed the strength of his brand, which has united various elements of what had been a broad but poorly articulated right-wing camp in Brazil. Bolsonaro cannot be written off especially given the very weak margin of victory.

President-elect Lula will have to deal with this new political landscape, which will pose a significant challenge to his administration's ability to pass legislation, implement reforms and fulfil large parts of his agenda. Lula has highlighted the importance of collaboration with states on issues such as environmental protection and Brazil's complex tax code, on which there is consensus across the political spectrum on the need for reform. The incoming government has promised to increase public investment and is calling for additional private investment to be channeled into infrastructure development through a new growth acceleration program, which he hopes can keep governors close to his side.

Some in the private sector remain uncertain on whether a Lula administration would interfere with the workings of the private sector. With that in mind most observers expect Lula to tread carefully, and they point to his more pragmatic instincts and past willingness to work with the private sector. The incoming Workers Party (PT) government is said to be sensitive to the importance of the private sector -not only at home – but its leading role in Brazil's export performance. There are clearly no upsides in alienating the vital private sector -especially as the Brazilian economy needs to be given all possible incentives to achieve a sustainable recovery – after many years of contraction or weak growth.

South Africa

South Africa is sub-Sahara's largest and most advanced economy – underpinned by a wealth of natural resources and a diversified industrial base. The economy is projected to grow by 1.5% in 2023. Real GDP shrank 0.7% in the second quarter of 2022 – reflecting disruptions including flooding, intense power cuts, rising interest rates and inflation. The country faces persistent structural constraints, high unemployment, a skills deficit, and worsening power shortages. Combined with weak demand (both domestic and global) these factors will weigh on domestic economic and export-oriented business activity next year.

South Africa's political climate threatens to become more uncertain ahead of general elections due in 2024. The ruling African National Congress (ANC) will hold its 5-yearly electoral summit in December 2022. Adding to the tension, the ANC faces the challenge of trying to rebuild its support. For the first time since the post-apartheid era, the ANC has lost its majority support in the country.

President Cyril Ramaphosa remains committed to expedite reforms – including measures to boost power supply and fight corruption-ahead of the 2024 election. His tightening grip on the government is positive for socio-economic reform, but South Africa is in a race against time to curb the risk of civil disorder fueled by poverty, high unemployment and inequality.

The fallout from the Russia-Ukraine war, extreme weather patterns, the worst power outages on record and a tough global backdrop will weigh heavily on the country's economic activity in 2023. Growth will be tepid in 2024-25, limited by fiscal constraints, slow progress on growth-enhancing reforms and low labor productivity.

Provided that global commodity prices and supply-chain disruptions start to ease, South Africa's inflation will likely decline from 2023 onwards. Power outages, which is stifling business activity, and fears of recession in the U.S. and Europe will weigh on confidence and the South African rand.

The market-determined exchange rate and independent central bank will tend to keep inflation risks lower than in many emerging markets (such as Turkey), although subdued price increases also reflect the fragility of domestic demand. Being commodity dependent, widely traded as an emerging market proxy, the rand is vulnerable to shifts in global sentiment. U.S. monetary tightening and faltering Chinese demand will raise currency risks, especially if commodity prices were to fall dramatically.

The South African Reserve Bank (central bank) raised benchmark interest rates by 75 basis points to 6.25%, in September 2022, repeating an identical increase agreed to in July. That has taken the cumulative rate increase to 275 basis points since November 2021, unwinding most of the 300-basis point coronavirus stimulus.

Regional recovery was disrupted this year by rapidly rising inflation, higher borrowing costs and softer demand in major export markets. Some of these factors will subdue growth prospects next year, but overall, South Africa and the region is expected to hold steady rather than suffer a major downturn in economic growth.

India

The economy is set to grow rapidly over the next decade. Forecasters expect India's economy to be the third largest by 2027, with GDP more than doubling from the current $3.4 trillion to $8.4 trillion over the next decade. Incrementally, India will add more than $400 billion to its GDP every year, a scale that is only surpassed by the U.S. and China.

These projections are underpinned by a confluence of favorable domestic and global forces. The most important change domestically is the shift in policy approach away from redistribution and towards boosting investments and job creation. This was evident in the introduction of the goods and services tax which crates a unified domestic market; corporate tax cuts; and production-linked schemes to incentivize investments from both within and outside India's borders. Overlaying this is the emergence of a multipolar world where companies are diversifying their supply chains, with India emerging as a destination of choice.

These forces are expected to integrate India's fast-growing workforce into the global economy. As it is, India already has a high global market share in services exports, and its lead has only increased since the onset of the pandemic as corporates became more accustomed to remote work.

India is now making concerted efforts to attract investments to boost manufacturing exports. These new factories and offices of the world will draw more employment into the formal sector and more crucially raise productive growth, creating a virtuous cycle of sustained growth. The shift in India's policy approach is moving it closer to the East Asian model of leveraging exports, raising savings and recycling it for investment. Against that background, forecasters believe India is entering a phase where incomes will be compounding at a fast rate. For context, India took 31

years since 1991 to raise its GDP by $3 trillion. According to projections, it will take just another seven years to grow by an additional $3 trillion.

India's GDP currently is where China's was in 2007 – a 15-year gap. However, from an outlook perspective, India's working age population is still growing, which suggests that it will have a longer growth runway. India's median age today is 11 years younger than China's. Productivity growth differentials should also swing in India's favor. Taken together, the expectation is that India's real GDP growth will average 6.5% over the coming decade while China's will average 3.6%.

China's industrialization drive, which propelled much of its growth over the past 30 years, has been enabled by a buildout of hard infrastructure like roads and railways. India is playing catch-up and is now making concerted efforts to raise the public expenditure on infrastructure. In today's world, a digital infrastructure is perhaps as important as the physical kind, and this is where India is taking a unique developmental approach. Unlike other economies where private networks have taken root, India has led in building public digital infrastructure. Further layers are being built, which will leverage this digital infrastructure to better match consumers and businesses, facilitate transactions, and ease the cost of doing business.

As a symbol of India's climb up the industrial value chain, Apple announced it has begun assembling its iPhone 14 in India. The government's aim, backed by incentives for investors in sectors such as electronics and pharmaceuticals, is to crest new jobs, bolster India's exports and reduce tech imports, largely from China, that are helping to fuel its current account deficit.

Indian officials are confident that a golden moment has arrived for their country, as multinationals are hedging their reliance on China. While it will take time, the momentum appears to be on the side of India eventually finding its way as an attractive alternative investment destination for both manufacturing and services.

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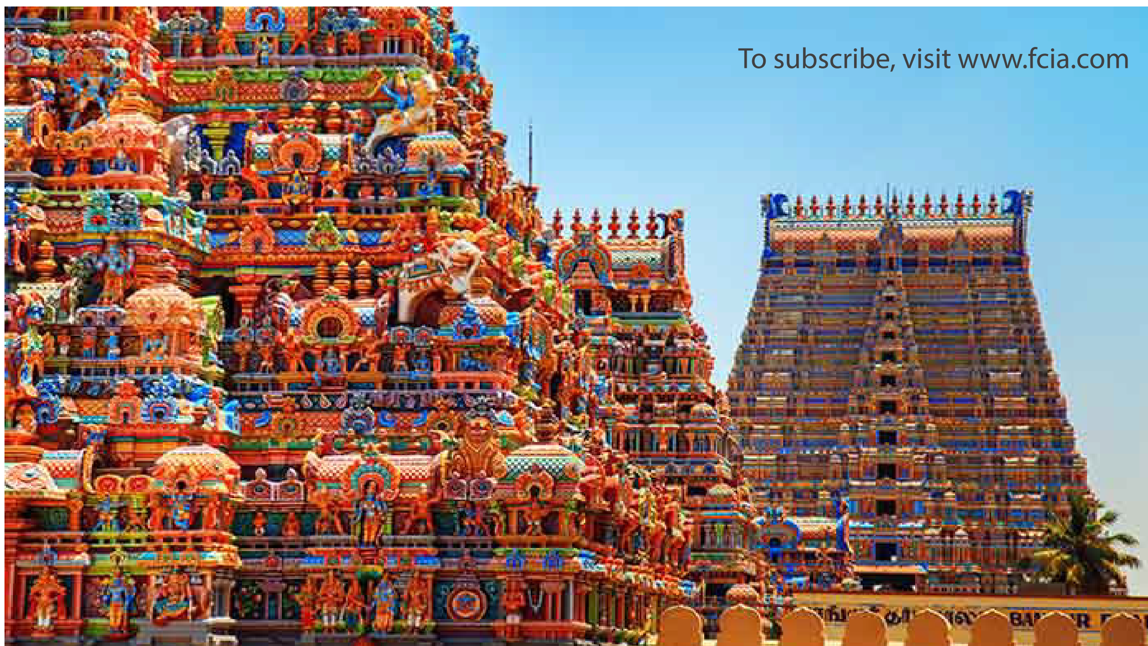

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