Major Country Risk Developments March-April 2024

By Byron Shoulton

Overview

The outlook for U.S. interest rates continues to suggest rates will stay higher for longer, as expected rate cuts may be delayed. The consensus is that interest rates will remain higher than the Federal Reserve's (the Fed) own estimates as it enters the looming rate-cutting cycle, as markets increasingly focus on where borrowing costs will settle. The strength of the U.S. economy has forced the scaling back of expectations for extensive interest rate cuts in 2024. Rapid developments in artificial intelligence and high government spending plans have boosted forecasts that rates will not fall as much or as quickly as previously predicted.

Recent inflation data gives pause, as the Fed's rate cutters seek more evidence that price gains are falling towards the central bank's 2% goal. This evidence is needed before the Fed will move to lower borrowing costs from their current 23-year high of 5.25%- 5.5%.

A sharp slowdown in price pressures during the second half of 2023 led rate-setters to shift from aggressive rate increases towards cuts. However, recent monthly price data has been disappointing. Signs are that inflation in the dominant services sector is proving stickier than expected. Meanwhile, the U.S. economy remains resilient, allowing poli-

cymakers to take a patient approach towards future rate cuts.

Europe

Southern European countries including Italy and Spain, the region's third and fourth biggest economies respectively, are expected to continue outperforming in 2024, as they experience new growth. Meanwhile, Germany and other northern economies such as Austria and the Netherlands remain stuck in a rut.

Projections are for the four southern European economies collectively to expand 1% more than Germany over the next two years. However, there are doubts this pattern will continue much beyond that point.

One recent study found that Austria, Belgium, France, and the Netherlands lost labor cost competitiveness due to rapid wage growth over the last four years, while competitiveness improved in Italy, Spain, Greece, and Ireland as a result of productivity improvements. By contrast, German labor competitiveness was flat.

Another factor influencing stronger growth in the southern economies is the European Union's (EU) 800 billion euros recovery fund. The Fund's mix of grants and cheap loans in return for growth-enhancing structural reforms have predominantly benefited the southern countries. Italy and Spain are the first and second-largest beneficiaries of the fund so far. Spain's growth has increased along with high immigration that boosted its labor force by 1.1% in 2023. This growth differential is not expected to continue over the medium term.

Germany's five leading economic research institutes have slashed their forecasts for 2024 GDP growth from 1.3% to 0.1%. They expect growth to recover to 1.4% in 2025. One factor weighing on Germany's growth has been a sharp tightening of fiscal policy to

reduce the government's budget deficit close to 2% in 2023 to comply with the return of the country's restrictive debt brake rule, which limits the amount of new debt it can issue and had been suspended since the start of the pandemic in 2020. Domestic demand in Germany has picked up less than expected. Consumers have reduced spending because of higher prices and borrowing costs. Meanwhile a loss of competitiveness for energy-intensive goods due to high gas and electricity prices continue to hurt German exports. Weaker global demand (notably from China) for machinery and equipment which is Germany's traditional strength has taken a toll.

The southern European economies have maintained a more supportive fiscal stance, with Italy's budget deficit rising to 7.2% last year. Italy plans to rein in spending to meet recently restored EU fiscal rules, meaning its recent outperformance is expected to fade over the next few years. Almost all of Italy's growth since 2019 stemmed from costly "superbonus" tax incentives that boosted private construction, but the scaling back of the scheme made such expansion unsustainable. The return of tourism, following the sharp downturn during the pandemic, has helped to boost the service sectors in southern Europe. The momentum in more travel and leisure activity continues in 2024.

Italy, Spain, Portugal, and Greece have collectively added more than 200 billion euros to GDP over the past six years, while Germany's GDP has expanded by only 85 billion euros in the same period. Germany's economy has barely grown since the pandemic. The two-speed eurozone economy has helped to narrow the gap between what it costs southern European countries to borrow compared to Germany. The spread between the 10-year bond yields in Italy and Germany, for example, recently sank to its lowest level.

Middle East

According to industry estimates, to meet global climate change targets by building solar power, turning car fleets electric and bolstering electricity grids – about $1.4 trillion needs to be spent on mining, refining, and smelting critical minerals over the next 25 years. Several Gulf countries including Saudi Arabia, United Arab Emirates (UAE), Oman and Qatar - hungry to diversify their economies beyond fossil fuels, are redirecting petrodollars to secure copper, nickel and other minerals used in power transmission lines, electric vehicles, and renewable power.

The Middle East region has the ambition and potential to create a major mining sector. For resource-rich Africa, Asia and Latin America, the entrance of the Gulf nations into the critical minerals battleground is a welcome alternative to decades of exploitative arrangements underpinned by either western colonialism or Chinese debt.

Getting investment from the Middle East allows resource rich countries to sidestep tensions between the U.S. and China over their copper, iron ore and lithium – resources both countries desperately need to electrify their economies over decades. The trend provides relief for countries from being seen in favor of one or the other of the big powers, U.S., or China.

The Gulf states trade openly with the U.S., China and with the rest of the world. With Gulf nations raking in $400 billion annually from fossil fuel exports but facing a future where hydrocarbons will be phased out, expanding into mining is a logical step. They have the advantage of being able to agree on government-to-government deals and have patient capital that come without having to choose between Chinese and western investors.

Saudi Arabia plans to have mining contribute $75 billion to its economy by 2025, up from $17 billion currently. Under the Saudis 'Vision 2030' initiative to modernize the economy, mining and minerals processing are earmarked to become the third industrial "pillar" next to oil and gas and petrochemicals. The Saudis are gearing up to exploit what is an estimated $2.5 trillion of domestic mineral assets with the help of Saudi Aramco, alongside state mining group Ma'aden. However, reaping the fruits of exploration will take years, or maybe decades. Hurdles include lack of water in the mainly desert country, few trained mining engineers, and scant high-quality mineral deposits. To address that, the kingdom aims to secure copper, iron, lithium, and nickel from overseas for processing domestically through Manara Minerals, a joint venture recently established between Ma'aden and the Public Investment Fund. In return for minority investments into established operations run by blue-chip companies such as BHP and Rio Tinto, it aims to receive metals supply – a model Japanese trading houses have successfully deployed for decades.

Gulf cash and political cover will enable industry giants to make riskier investments. Through such investments, Saudi Arabia aims to position itself at the center of a super region, spanning Africa, central Asia and south Asia. In January, Saudi Arabia signed deals to explore mining projects in Egypt, Morocco, Russia and the Democratic Republic of Congo (DRC). By wielding its cheap, abundant energy, it can process the raw materials from resource rich nations starved of finance, to manufacture products such as steel or electric cars for rapidly growing markets.

Oman has started construction of what could be the world's largest green steel plant that plans to use

iron ore from Cameroon.

The Qatar Investment Authority, the state's sovereign wealth fund, is now Glencore's second-biggest shareholder. For international mining groups also seeking to navigate U.S.-China tensions over natural resources, the Middle East offers a neutral venue for minerals processing, capital, and corporate headquarters. SRG Mining, a graphite miner caught in a political firestorm in Canada over a failed plan to collaborate with a Chinese company, announced that it will move to the UAE. There are several other examples of mining firms establishing a presence in the UAE to take advantage of its strategic assets.

The UAE Is keen to advance its strategic objectives through mining. It is pursuing government-to-government engagements with some focus on the African continent. Its International Resource Holding (IRH) courted the leadership of the Zambian government for two years. Last December IRH agreed to buy a 51% stake in Zambia's Mopani copper mine for $1.1 billion. Mopani, a troubled but rare asset formerly owned by Glencore, had drawn several lucrative offers from leading global mining companies, eager to gain access to a metal that is crucial to clean energy technologies of the future. The list narrowed down to Chinese and South African mining giants, but the UAE company was selected instead.
However, Gulf investment also comes with risks. Sovereign wealth funds can bring complexity, lack of transparency and less accountability when mining projects and local communities need more accountability and transparency. Nonetheless, western countries have welcomed the Gulf's expanding role in mining to break China's monopoly over processing critical minerals. For example, the U.S. have reportedly encouraged Saudi, Emirati, and Qatari investments in the Democratic Republic of Congo, where western companies struggle to enter, in order to help counter China's dominance.

India

Today, India is one of the world's largest and most vibrant economies. It has managed its democracy according to its own culture and traditions. India's attractiveness for investment, and as a geopolitical partner for countries wary of an increasingly authoritarian China, relies in large part on its image as a democratic, law-based state. However, there appears to be an ever-wider gap between Prime Minister Modi's pro-democratic rhetoric and reality. A desire to woo India has often led western democracies to look the other way over democratic backsliding. Prime minister Modi (PM) has set a target for India to become a developed country by 2047. Preserving political freedoms is in the best interests of Indian growth and prosperity, and the Modi government's ambitions to enhance the country's role as a leading member of the global community.

In the run-up to general elections due on April 19th India's ruling BJP Party is busy mobilizing support at home and abroad. The elections will decide if PM Modi gets re-elected to serve a third term. Recent arrests of opposition figures and an intensified clampdown on opposition parties, have caused raised eyebrows, especially as there is a perception that Modi has a strong lead, which should assure the BJP's victory in the upcoming 44-day-long polling.

PM Modi's apparent success in moving India into the 21st century over the past ten years, plus his generally positive image globally, seems almost certain to make him the favorite among India's 900 million+ registered voters. To its credit, India trades and maintains relations with most countries; and PM Modi has been particularly skillful in staying neutral in global conflicts. India has served as a key alternative refining location for Russian crude, circumventing western sanctions imposed over the war on Ukraine.

The BJP's rivals have failed to present a compelling alternative to its policies; and the multi-party India National Development Inclusive Alliance, formed as a supposedly united opposition front, has been dogged by squabbles and defections to the BJP. Meanwhile, the opposition Congress Party, while highlighting India's social problems and Mr. Modi's increasingly authoritarian methods, appear to be making little progress attracting more of the electorate, or in presenting a coherent platform.

Still, despite being among the fastest growing economies, the World Bank considers India (and its neighbors Pakistan, Bangladesh, and Sri Lanka) to be failing in creating sufficient jobs to sustain their young populations.

India, which last year overtook China as the world's most populous country with 1.4 billion people, is expected to record GDP growth of 7.6% this year, up from 7% last year. However, the World Bank notes

that the share of the working-age population was falling. The employment ratio for South Asia was 59% in 2023, compared with 70% in other emerging markets. The assessment is that private companies in sectors such as manufacturing and services have not grown enough to absorb workers leaving the agricultural sector. The lack of jobs for women also remains a challenge. Female employment ratio is among the lowest in the world, at less than 40%. The issue of joblessness has become particularly fraught in India, which has struggled to create enough work despite its rapid economic growth. Youth unemployment stood at 45.4% in 2023. The opposition Congress Party is seeking to make joblessness a political issue ahead of the election, accusing the government of trying to "cover it up."

PM Modi's close association with help for the poor could play a key role in deciding whether the BJP retains power in the upcoming election. Since taking office in 2014, Modi has presided over an expansion of programs for India's poorest. In fiscal year 2022-23, total spending on his seven largest subsidy schemes totaled $82 billion, more than twice the amount spent in 2014-15, Modi's first year in power.

The schemes include the free food grain program that reaches 813 million people, and housing and health insurance schemes. Government handouts and subsidies long predate Modi's ascent to power. He has only taken it to a new level, transforming welfare distribution. Food security is a long running issue in India, which suffered major famines in the past. India's Supreme Court in 2001 upheld a constitutional right to food. After a long-running push by civil society groups India passed a national food security act in 2013.

Meanwhile, Tesla Motors will be scouting locations in India for a proposed $2-$3 billion electric car plant. The step towards making electric vehicles (EV) in India comes after the country lowered tariffs on higher-priced imported EV's for companies that commit to making them in the country within three years. The tariff cut was a concession Tesla had been pushing for as a precondition to investing.

A confirmed Tesla investment would be a major boost for PM Modi's government ahead of the general elections, as his record on business and job creation will be in sharp focus. Modi has earmarked billions of dollars' worth of government subsidies to promote manufacturing, including critical industries such as EV's, where India's geopolitical rival China has a strong lead.

Tesla is considering building a smaller car than its current models in the proposed new factory, which would be priced at less than $30,000. It would sell the model in India and export to south-east Asia, the Gulf, Africa, and southern and eastern Europe. The company expects the factory to reach production of as many as 500,000 cars a year when it reach-

es full capacity. Tesla might later consider setting up its own battery plant, following the "gigafactory" model it has followed at plants in California, Texas, Germany, and Shanghai, where suppliers have set up shop next to or near the mother plant. In addition to Tesla's $2-$3 billion investment in the Indian car plant, suppliers to Tesla would invest billions more, making this one of India's biggest inward foreign investments.

India has been much slower to build and adopt EV's and charging infrastructure than China, whose top producer BYD is Tesla's closest rival in terms of global sales. BYD submitted a proposal to build a plant in India last year in partnership with an Indian company, Megha Engineering. However, according to the Indian government, so far, the project has failed to secure approval.

India in 2020 introduced stringent restrictions on countries with which it shares a land border, measures that are seen as targeting China.

Alongside local EV makers including Tata Motors and Mahindra, Vietnam's Vin Fast plans to build a $2 billion plant in the Indian state of Yamil Nadu. Indian steelmaker JSW announced it was launching a $1.5 billion tie-up with China's SAIC Motors to build and sell EVs in India.

India is reportedly receiving a significant boost from investors moving their money away from China as geopolitical tensions reshape the global venture capital market. Investment activity has picked up pace, with some analysts projecting that in 2024 there will be double the amounts deployed in India during 2023.

In March Switzerland, Norway, Iceland, and Liechtenstein, finally signed a free trade agreement between their European Free Trade Association and India. This comes after 16 years of negotiations. Separately, India's government signed off on a plan to lower import taxes on some higher-priced, imported electric vehicles. In both cases there was something substantial for India: a promise of new investments.

Malaysia

As companies around the world look for a back-up to China to protect themselves from geopolitical disruptions, Malaysia is becoming a more attractive investment destination.

Malaysia is an export-driven economy with a diversified industrial product mix. Key commodity exports include crude oil and palm oil, alongside electronic goods. It has a well-developed financial services sector.

GDP growth is forecast at 4.4% in 2024 as the downturn in global electronics demand eases. Subsiding inflation (2.6%) and monetary easing will facilitate private consumption and investment in 2025, fueling GDP growth of 4.5%. Private consumption is expected to be the main driver of medium-term growth. Its fiscal deficit will average 3.8% of GDP in 2024-28 according to the EIU, compared with a deficit of 5.8% in 2020-23. Public debt is projected to be at 64% of GDP by 2028. Risks related to debt servicing are low.

The country has a 50-year history at the backend of the semiconductor manufacturing supply chain: packaging, assembling and testing chips. Today it has ambitions to move up to the front end of a $520

billion global industry that powers everything from televisions to smartphones and electric vehicles. That includes higher value activities such as wafer fabrication and integrated circuit design.

The broadening of U.S. curbs on Chinese technology, especially for chipmaking, are a key reason for neutral Malaysia's appeal. As the U.S. jostles with China for global technology supremacy and has enlisted support from allies in Europe and Asia as it restricts sale of the most advanced chips and manufacturing equipment to its geopolitical rival. It is not only Chinese companies setting up in Malaysia. There are Korean, Japanese, and western companies as well. All are there in response to the technology war between the U.S. and China. Some companies are building parts, such as machine frames, for clients in the U.S. While major western semiconductor equipment manufacturers cannot sell their most advanced equipment to China because of U.S. restrictions, however these manufacturers source parts from Chinese companies. They tell their suppliers: if you do not move out of China, we will have to find new sources of supply. Thus, Chinese companies are forced to move or expand to places like southeast Asia, so as not to lose business and that includes Malaysia.

Investment is booming. The state attracted $12.8 billion in foreign direct investment in 2023, more than the combined total inflows during 2013-2020. Developing Malaysia's semiconductor industry and workforce into this higher value manufacturing is a critical goal for the government of Prime Minister Anwar Ibrahim. Mr. Ibrahim believes this is a critical moment for his country as it absorbs the boom in investment, job growth and advancement in high-tech activity.

Still, the advance has distinct vulnerabilities, includ-

ing a severe talent shortage and a failure to create a domestic semiconductor champion that can draw in others. Another is politics. The U.S. has already put pressure on Malaysia for “tilting” towards China under PM Anwar, who took office in 2022. The U.S., the biggest contributor to Malaysia’s foreign direct investment, may clamp down further on Chinese technology. Some analysts and industry groups fear that the U.S. may restrict products and equipment built in Malaysia by the flood of new Chinese companies. Nonetheless, Malaysia will be a part of the supply chain for semiconductors going forward.

Diversification from China remains a top focus for companies. This makes Malaysia’s (Penang region) one of the most interesting spots in Asia now. Most of the global semiconductor manufacturing majors have a presence there or will soon have one.

Malaysia will avoid choosing sides between the U.S. and China. Although the country leans towards China economically (China was Malaysia’s largest trading partner in 2023), it relies on the U.S. as a security partner in the region, particularly in the maritime domain.

Indonesia

Indonesia is one of the fastest- growing ASEAN countries, and private consumption and investment spending will support growth in 2024-25. The economy is expected to remain on a stable growth path. The central bank ended its tightening cycle in January 2023. Easing consumer price inflation and the need to support economic growth will prompt it to loosen its monetary stance by mid-2024. Political stability will be ensured, as the new government is expected to maintain its predecessor’s big-tent ap

proach, minimizing internal conflict. Ongoing rail infrastructure projects will connect major cities, but projects will be prone to delays.

The production and processing of raw commodities dominate Indonesia’s export basket, leaving the external sector exposed to fluctuations in global commodity prices. Large-scale foreign direct investment (FDI) inflows are required to improve infrastructure and develop the manufacturing sector. The reforms needed to attract such funds are likely to be implemented in a slow and piecemeal fashion, with the government focusing on reducing red tape and regulatory requirements.

The country faces no immediate threat to its sovereignty, despite a decades-long, low-level insurgency in West Papua province. The country continues to take a diplomatically neutral stance on regional security concerns. Indonesia has the largest Moslem population outside the Middle East, and the government does not tolerate extremism. The security forces have uprooted most of the country’s terrorist

cells.

Indonesia will press ahead with plans to expand nickel output despite a supply glut that is forcing rivals to shut down mines. Indonesia is the world's top nickel producer and aim to keep prices low and protect long-term demand for the metal which is crucial to electric car batteries.

The country's production capacity for battery-grade nickel is expected to quadruple to 1 million tons by 2030. Capacity for nickel pig iron, which is used to make stainless steel, is projected to expand by up to 15% in three years from the current 1.9 million tons.

Nickel prices have slumped 30-40% over the past year on elevated supply from Indonesia and softer global demand. More than half of global nickel production is reportedly unprofitable at current prices of around $16,500 per ton. According to Indonesian producers, there is no reason why the country should not expand its production for battery materials. The aim is to achieve price equilibrium as the biggest producer of the metal. The Indonesians see this as the responsibility of the lead supplier to produce enough nickel so that the EV transition can progress smoothly.

Looking ahead, the surge in low-cost nickel supplies from Indonesia will likely wipe out rivals over the next few years. Already, two major producers in western Australia have closed mines while another is considering closure of some nickel operations. Indonesian producers see the country's increased output amid output cuts elsewhere, as likely to

help stabilize nickel prices that have been volatile in recent years. They project long-term nickel prices-which briefly traded above $100,000 per ton in 2022- would settle between $18,000 and $19,000.

Indonesia had previously proposed a nickel version of the OPEC group of oil-producing nations. However, southeast Asia's biggest economy was well positioned to shape global supply and prices on its own. With the world's largest reserves of the mineral, Indonesia commands a market share of more than 50%.

There is the prospect of consistently higher prices pushing carmakers away from nickel-based batteries towards cheaper, nickel-free options such as lithium iron phosphate batteries. In the short term, there is good profitability with higher prices. But if this high level is maintained, there is the likelihood that the market shifts and producers would sacrifice long-term demand. Indonesia is eying the downstream program. The country has in recent years contemplated building a domestic EV ecosystem on the back of its vast nickel reserves. Outgoing President Joko Widodo banned nickel ore exports in 2020, forcing smelters and battery makers to set up plants in the country.

Mr. Widodo's successor Prabowo Subianto, who will take over in October 2024 following his recent landslide election victory, has vowed to maintain that trajectory. Carmakers such as China's BYD have announced plans to establish manufacturing operations in Indonesia. Chinese companies have poured in billions of dollars and control the country's biggest nickel operations.

Any significant threat to nickel demand would damage Indonesia's economy. Foreign direct investment has hit records in recent years, and the current account balance reached a surplus in 2021 after a decade of deficits thanks to the boost to the domestic nickel industry. From Indonesia's perspective, Indonesians need to protect the industry as it is a substantial revenue source and contributor to the economy. They have reason to try to keep prices at a sustainable level, and they have some leverage to achieve this. According to one independent estimate, Indonesia 's annual nickel output will grow to 3.02 million tons by 2030 and account for 65% of global supply, up from 1.71 million tons, or 51% in 2023.

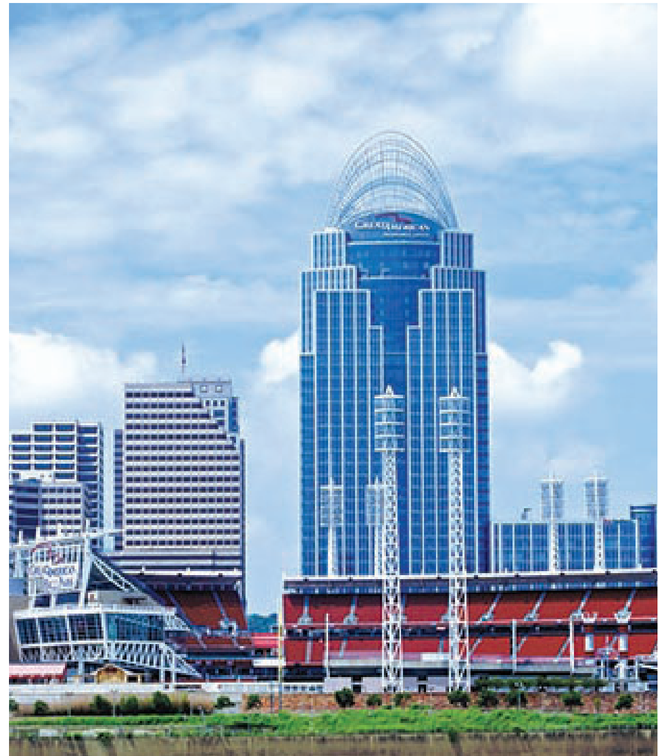
Indonesia also maintains an optimistic outlook on demand for EVs, despite a recent slowdown flagged by Tesla and other carmakers. The Indonesian government is confident that the appetite for nickel batteries, which have higher recycling potential and better performance than lithium iron phosphate batteries. Lower nickel prices might not guarantee sustained demand as lithium batteries are cheaper. Indonesia's expansion of production would be more problematic for other nickel producers over the longer term.

Meanwhile, global mining companies have called for a green premium for sustainably produced nickel traded on the London Metal Exchange, as flood of allegedly "dirty" supplies from Indonesia squeezes profits for producers. BHP, the world's largest mining group, has been pushing the LME to distinguish between so-called dirty nickel and cleaner supplies.

Nickel mining in Indonesia has faced growing criticism from environmental groups for causing forestry loss, mining waste pollution and high carbon emissions because of reliance on coal-fired power. In response the LME said the market for green nick-

el is not large enough to support vibrant trading in dedicated green futures contracts.

Separately, weather conditions are expected to hurt Indonesia's coffee exports for a second consecutive year. Indonesia is the world's third-largest coffee producer (after Brazil and Vietnam). As a result, global coffee bean futures are near record highs. Markets are not expecting a quick return to normal. Following last year's low harvest in Asia, some farmers have switched from coffee to rubber, which is easier to produce in warmer humid weather. The timing is unfortunate for coffee-related businesses. Consumption in south-east Asian countries has been soaring, with demand in Indonesia alone doubling over the past decade.



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