Major Country Risk Developments
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By Byron Shoulton

Special Recognition

This edition celebrates Byron's 40th anniversary at FCIA. This is a great milestone for anyone, as not many can claim such an accomplishment!

We would like to recognize Byron's contributions to FCIA and our insureds for his economic updates through so many financial crisis around the world during his tenor.

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Overview

Global trade is slowly recovering from the Covid-19 related lockdown lows and earlier predictions of mass reshoring of production may not come to pass. The costs of reconfiguring some of the existing supply chains are considered simply too great. Most importantly, there are signs the international response is shifting.

While several governments met the initial Covid-19 outbreak with a raft of trade restrictions, mostly to prevent exports of medical supplies, G20 economies had repealed about 36% of the pandemic-related trade restrictions by mid-May, according to the latest report on G20 trade measures by the World Trade Organization. Since the initial outbreak, the world's 20 largest economies, which make up about 90% of global output and 80% of trade, have also lowered barriers to imports of many virus-related products.

USA

U.S. employers added 4.8 million new jobs in June bringing the unemployment rate down to 11.1%(-from 13%) as the economy reopened and before a recent spike in new Covid-19 cases. Some policymakers have warned that the rebound in the U.S. is in danger of stalling as a result of the recent spike in coronavirus infections across several large U.S. states. The Federal Reserve Bank of Atlanta, whose district covers some of the regions hardest hit by the current outbreaks, point to recent data which has shown a levelling off of economic activity both in terms of business openings and mobility. This trend suggests that the trajectory of the recovery in the U.S. is likely to be bumpy over the next several months.

U.S. jobs data for May and June show that American employers have added back 7.5 million of the 22.2 million jobs lost since the outset of the pandemic. This sparked hopes of a faster rebound in the labor market. But the June data were collected before a surge of infections in several large states, including Florida, Texas, Arizona and California, causing local officials to reimpose some restrictions introduced during the initial lockdowns. As a result, more workers will remain unemployed for longer. The renewed acceleration of infections could encourage new caution by consumers and businesses. A shortage of supplies, skyrocketing growth in new cases and backlogs at labs are leading public health officials in many large cities to limit testing to only people showing symptoms — a return to restrictions that were in place in many parts of the country during the earlier days of the outbreak.

In addition, without additional federal support—which may, or may not, be forthcoming—state and local governments face a substantial revenue shortfall in the coming fiscal years. Hence, Fitch forecasts state and local fiscal contraction that grows to 0.75% of GDP by 2022, even as support from four federal stimulus packages wanes. Consequently, the forecast for growth in 2021 has been revised from 5.2% to 3.7%. Real GDP is forecast to regain its previous peak in mid-2022.

Employment statistics for June were better than expected but centered around the nadir of daily COVID-19 infections. Hence, while they suggest a lower initial path for unemployment, given the downward revision to the GDP forecast for 2021, the economy is not expected to regain full employment until 2024. With slack labor markets and firms competing for reduced business, inflation is expected to average 1.6% through 2025, well below the Fed's 2% objective.

The pandemic's economic effects linger in many other parts of the world. The health crisis and its related economic slowdown have cast doubt on whether China can meet its targets to buy U.S. goods agreed to under the recent interim trade deal—with energy emerging as the likely biggest casualty. China remains far behind its target for purchases of U.S. oil, natural gas, and refined petroleum products like propane and butane. The deal's targets implied that China would purchase around $25 billion of U.S. energy in 2020 and even more in 2021. The latest data on U.S. exports show China has purchased only $2 billion of that sum so far this year. The U.S. energy industry, concerned about the slow purchasing pace of the world's second largest economy, expects the U.S. to turn up the pressure on China.

Some bright spots mitigate the gloom. Following the sharp tightening during January–March, financial conditions have eased for advanced economies and, to a lesser extent, for some emerging market economies, reflecting the formidable policy actions that were taken by various central banks. Sizable fiscal and financial sector countermeasures deployed in several countries since the start of the crisis have prevented worse near-term losses. Reduced-work-hour programs and assistance to workers on temporary furlough have kept many from outright unemployment, while financial support to firms and regulatory actions to ensure continued credit provision have prevented more widespread bankruptcies. Fiscal measures amounting to about $11 trillion have been announced worldwide.

Swift and, in some cases, novel actions by major central banks (such as a few emerging market central banks launching quantitative easing for the first time and some advanced economy central banks significantly increasing the scale of asset purchases) have enhanced liquidity provision and limited the rise in borrowing costs. Moreover, swap lines for several emerging economies are helping to maintain adequate liquidity and helping them keep debt repayments current. Meanwhile, global oil markets appear to be gaining a sense of stability.

A recovery is underway as drivers return to roads--and even if the upturn in fuel demand slows, some traders are confident that the recent supply declines will prevent another collapse in oil prices. Some U.S. oil companies have indicated they would start bringing back output in response to the price rebound. If crude prices continue climbing, investors expect more U.S. suppliers and OPEC producers to gradually increase supply. The recent rebound comes after prices suffered their biggest quarterly percentage drop on record in data going back to 1983 in the first three months of the year. Brent crude, the global gauge of oil prices, has recovered to $41.15 per barrel.

Stability in the oil market has helped lift sentiment. West Texas Intermediate oil futures, which had sunk deep into negative territory for contracts expiring in the early summer, have risen in recent weeks to trade in a stable range close to the current spot price. Oil futures indicate that prices are expected to increase by year-end and thereafter toward $46 per barrel, still about 25% below the 2019 average. Nonfuel com-

modity prices are expected to rise marginally faster than previously assumed.

Exchange rate changes have reflected these developments. As of mid-June, the U.S. dollar had depreciated by close to 4% (after strengthening by over 8% between January and early April). Currencies that had weakened substantially in previous months have appreciated —including the Australian dollar and the Norwegian krone, among advanced economy currencies, and the Indonesian rupiah, Mexican peso, Russian ruble, and South African rand, among emerging market currencies.

Based on downside surprises and weak high-frequency indicators, the current forecast factors in the big hit to activity in the first half of 2020 and a slower recovery path in the second half than initially envisaged. For economies where infections are declining, the slower recovery path in the forecast reflects key assumptions: persistent social distancing into the second half of 2020, a greater impact from the larger-than-anticipated hit to activity during the lockdown in the first half, and a negative impact on productivity as surviving businesses enhance workplace safety and hygiene standards. For economies still struggling to control infection rates, (e.g. Brazil, Russia, South Africa, et al) the need to continue lockdowns and social distancing will take an additional toll on economic activity over the coming months.

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The impact of the sizable fiscal countermeasures implemented so far and anticipated for the rest of the year will act as major economic stabilizers. With automatic stabilizers also allowed to operate and provide further buffers, overall fiscal deficits are expected to widen significantly and debt ratios to rise over 2020–21. Major central banks are expected to maintain their current settings throughout 2020 and possibly to the end of 2021. Financial conditions are expected to remain approximately at current levels-for both advanced and emerging market economies. Government borrowing costs in the eurozone have fallen back to levels last seen before the start of the coronavirus crisis, underlining the success of the European Central Bank (ECB) and other economic policymakers in restoring confidence among debt investors. Bond yields in Italy and other southern European nations spiked in March when it became clear that the pandemic and the resulting shutdowns would lead to a collapse in economic activity, just as governments were borrowing heavily to support businesses and households. Yields rise when prices fall. But the ECB's massive program of asset purchases — announced in mid-March at €750 billion and expanded last month to €1.35 trillion — has since improved sentiment, pulling borrowing costs back down and making investors more confident about holding the debt of weaker sovereigns.

Global GDP growth is projected at –4.9% in 2020. Consumption growth has been downgraded for most economies, reflecting the larger-than-anticipated disruption to domestic activity. The projections of weaker consumption spending reflect a combination of a large adverse demand shock from social distancing and lockdowns, as well as a rise in precautionary savings. Moreover, investment is expected to be subdued as firms defer capital expenditures amid continued high uncertainty. Policy support has partially offset the deterioration in private domestic demand.

Global GDP growth in 2021 is optimistically projected by the IMF to strengthen to 5.4%. Consumption is projected to strengthen gradually next year, and investment is also expected to firm up, but will likely remain subdued. Growth in the group of advanced economies is projected at –8.0% in 2020. The Organization for Economic Cooperation and Development forecast that unemployment levels in advanced economies will likely end 2020 higher than in any year since the Great Depression. There appears to have been a deeper hit to economic activity in the first half of the year than anticipated. This also

suggests a more gradual recovery in the second half as fear of renewed spikes is likely to continue. Synchronized deep downturns in 2020 are foreseen in the United States (–8.0%); Japan (–5.8%); the United Kingdom (–10.2%); Germany (–7.8%); France (–12.5%); Italy and Spain (–12.8%). However, growth in 2021 in the advanced economies is projected to strengthen to 4.8%.

In **China**, where the recovery from the sharp contraction is underway, growth is projected at 1.0% in 2020, supported in part by policy stimulus.

India's economy is projected to contract by 4.5% following a longer period of lockdown and a slower recovery.

In **Latin America,** where most countries are still struggling to contain infections, the two largest economies, Brazil and Mexico, are projected to contract by -9.1% and -9.7-%, respectively in 2020. The disruptions due to the pandemic, as well as significantly lower disposable income for oil exporters after the dramatic fuel price decline, imply sharp recessions in Russia (–6.6%), Saudi Arabia (–6.8%), and Nigeria (–5.4%), while South Africa's performance (–8.0%) will be severely affected by the health crisis.

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There is pervasive uncertainty around these forecasts. Much will depend on the strength of the recovery in the second half of 2020 as well as the magnitude and persistence of the adverse shock. These elements, in turn, depend on several uncertain factors, including:

• The length of the pandemic and required lockdowns.
• How long voluntary social distancing holds, which will affect spending.
• Displaced workers' ability to secure employment, possibly in different sectors.
• Impact of company closures and unemployed workers exiting the workforce, which may make it more difficult for economic activity to bounce back once the pandemic fades.
• The impact of changes to strengthen workplace safety—such as staggered work shifts, enhanced hygiene and cleaning between shifts, new workplace practices relating to proximity of personnel on production lines—which incur business costs.
• Global supply chain reconfigurations that affect productivity as companies try to enhance their resilience to supply disruptions.

For the first time, the IMF projects that all regions will experience negative growth in 2020. There are, however, substantial differences across individual economies, reflecting the evolution of the pandemic and the effectiveness of containment strategies; variation in economic structure (for example, dependence on severely affected sectors, such as tourism and oil); reliance on external financial flows, including remittances; and pre-crisis growth trends.

Mexico

The government of President Andres Manuel Lopez Obrador faces his biggest challenge in the months ahead as it struggles to contain the health and economic impact of the Covid-19 pandemic. Numbers of cases and deaths are rising rapidly, and on June 21st the country recorded more deaths in one day (1,044) than any other country. The government has so far offered only limited measures to cushion the economic blow. The president has rejected calls for fiscal stimulus, on the basis that the government should not take on debt to support companies.

As the economic costs mount, pressure on the president will grow; polls show that public approval of the

government's handling of the crisis has declined in recent weeks. The government's delayed response to the pandemic (and the country's limited medical capacity) will add to growing citizen concerns regarding the president's failures to enact other parts of his agenda, including insecurity and corruption.

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The rebranded U.S.-Mexico-Canada Agreement (USMCA), which replaced the North American Free Trade Agreement (NAFTA), went into effect on July 1, 2020 and the U.S. continues to dominate Mexico's trade flows despite steps to diversify trade partners. Still, the USMCA together with greater investments by China will likely facilitate Mexico's continued export growth.

Limitations of fiscal reform and continued low oil revenues (compared with pre-2014 levels) amid Covid-19 restrictions could encourage the federal government to consider further fiscal measures. Meanwhile, liquidity concerns amid the pandemic are limiting credit growth especially for small and medium sized enterprises (SME's).

Business confidence in the Lopez Obrador government remains low amid changes to the rules of the game. The enforcement of competition policy in Mexico continues to face stumbling blocks, despite improvements in legislation. Efforts to reduce labor informality continues, but progress is slow amid high crisis-related unemployment. New labor reform promises to increase collective bargaining and strengthen unions. But the labor market continues to struggle, owing to low wages and overall poor worker protection.

The next elections (congressional, provincial and municipal) are due in June 2021. Given the government's poor handling of the pandemic, the elections will now be more competitive than previously. Still, traditional opposition parties such as the PRI and the PAN – both of which suffered heavy losses in the 2018 vote – remain weak and demoralized and have not yet been able to capitalize on the ruling party's weakness. In fact, a recent poll showed 60% of voters said they did not back any political party. The president's left-wing Movimiento Regeneration Nacional (Morena) is likely to lose its current super-majority in the Chamber of Deputies (the lower house), meaning that the second half of Lopez Obrador's term will be defined by high levels of political polarization and legislative gridlock.

Foreign policy has taken a back seat under Mr. Lopez Obrador as the president has focused on domestic policy, with little emphasis on Mexico's international role. For example, he has not traveled abroad as president and has missed important global meetings. Mexico will begin a two-year term on the UN Security Council as of January 1, 2021, which will force it to take sides on some global issues. Lopez Obrador is expected to focus primarily on Mexico's ties with the U.S. – the country's dominant trade and investment partner, and home to almost 12 million of its emigrants. Despite occasional harsh rhetoric by President Trump, the relationship between both leaders has remained cordial.

Over the coming months, the government will be preoccupied with responding to the Corvid-19 outbreak, rather than addressing Mexico's structural shortcomings. Although cases continue to rise, the government began a phased reopening on May 18th, with some key sectors (such as manufacturing, mining and construction) permitted to start operating. Government support so far has been aimed at Mexico's poorest. Since coming to power in 2018, the government has implemented a cumulative 39% rise in the minimum wage.

To combat the pandemic, the administration has redirected $10 billion in government spending towards programs targeted at helping the poorest, although this has come at the expense of reinforced austerity elsewhere, including a further reduction in public sector salaries. However, the administration has yet to announce economic support measures for companies or workers. This will be particularly important for informal sector employees, who make up about 60% of the labor force. In the absence of government support, some state and the private sector have stepped into the void. States have offered to suspend tax payments for business, and the powerful business lobby has agreed $12 billion in loans from IDB Invest (part of the Inter-American Development Bank) to help small and medium-sized enterprises to weather the crisis.

The pandemic will exact a huge economic toll on Mexico. The Economist Intelligence Unit forecast a 9.7% contraction in real GDP in 2020, driven by steep declines in private consumption and investment, and only a modest increase in government consumption. The effects of weak external and domestic demand will persist over the summer, given the country's relatively late response to the crisis. Amid a lack of fiscal stimulus, recovery in GDP growth in 2021 will be weak, as business activity struggles to return to pre-crisis levels, causing knock-on effects for private consumption amid slow jobs growth.

Growth will remain weak owing to slowness in restoring global supply chains in manufacturing, slow pick-up in tourism, a weak recovery in workers remittances (which support Mexican consumption) and continued weak investor confidence. The government has taken out a $1 billion loan from the World Bank to help support its public finances amid the pandemic. The loan comes with a reference rate of 0.25%, as well as a 0.25% annual rate for its duration; it is expected to be paid off in biannual installments until 2034. The cost of the loan is considerably less than the amount that Mexico is currently obtaining through global bond issues, particularly considering the rising premiums on its debt over the past year amid credit rating downgrades and concerns about the financial viability of its energy agenda.

Amid a lack of fiscal stimulus, recovery in GDP growth in 2021 will be weak, as business activity struggles to return to pre-crisis levels, ...

The peso's value has dropped dramatically in 2020. In normal circumstances this would create substantial price pressures. However, in the current environment the effects will be limited. Weak consumer demand and lower oil prices during the pandemic will likely cause inflation to slow to around 3.4% at year-end 2020. Meanwhile, increased demand-side pressures and shortages amid supply chain disruptions will drive inflation to 4.2% at year-end 2021.

In its latest effort to provide a monetary boost to the struggling economy, the central bank lowered the policy interest rate by 50 basis points to 5% on June 29th. This is the fourth consecutive 50-basis-point cut in a cycle of monetary easing that began in August 2019 in response to a weakened economy.

Advanced fourth-generation (4G) and fifth-generation (5G) mobile connectivity continues to expand rapidly and will help to improve business opportunities as the number of internet users exceeds 100 million in 2022-24.

Some of Mexico's most popular tourist resorts reopened to tourists in June; with Cancun, Maya Riviera and Baja California Sur welcoming foreign visitors for the first time in months. Still, social distancing measures remain in place and hotel occupancy rates continue to be very low. Amid much reduced revenue, the tourism sector is seeking greater support from the government to stay afloat.

Brazil

Brazil's large and diversified economy makes it attractive for investors, but the post-Covid-19 recovery will be tepid, dampening foreign direct investment inflows, and will take several years. Brazil lost its investment-grade rating in 2015 and is unlikely to regain it for some time. This year's economic crisis will lift the public debt/GDP ratio to near 100%, which is very high – requiring consolidation measures that will further crimp economic growth.

The political environment is another weakness, given a fragmented Congress and an unconventional president. Although the leftist opposition is weak, powerful centrist parties are aligned with some aspects of the government's agenda, notably tax simplification. They are likely to resist the more radical, free-market measures of the economy minister. Corruption remains problematic, but companies are strengthening governance.

Crisis management resulting from the Covid-19 pandemic will push back government efforts to make improvements in the business environment. Brazil's large economy is attractive, but poor government effectiveness, a burdensome tax system, archaic infrastructure and skills shortages will continue to impair business. Progress on structural reforms will be delayed further given this year's economic crisis. Fiscal consolidation efforts post Covid-19 will likely weigh on structural reform progress. Brazil remains in the lower half of the business environment global ranking in the 2020-24 forecast period. After years of protectionism, the government wants to reduce trade barriers, with cuts in capital goods and technology imports likely.

A tepid recovery from this year's economic contraction related to Covid-19 - together with currency volatility- will cause larger than normal fluctuations in Brazil's market size, and it will take several years for the country to recover to pre-crisis levels. In 2019

This year's economic crisis will lift the public debt/GDP ratio to near 100%, which is very high – requiring consolidation measures that will further crimp economic growth.

Brazil ranked as the ninth-largest economy in the world, with a total GDP of just over $1.8 trillion, just below Italy but above Canada, Russia, South Korea, Spain and Mexico. However, given its large population (more than 210 million), GDP per head was $8,753 in 2019, falling to $6,620 in 2020. It is forecast to recover to $8,473 by 2024, placing Brazil as an upper-middle country or the 60th richest country in the world.

The high share of income diverted to consumption means that household consumption represents about 65% of the country's total GDP. Government consumption is fairly high for a developing country, about 20% of GDP. The flip side of this equation is that both savings and investments are very low, with gross fixed investments representing only 15% of GDP. Low levels of savings reduce the amount of financial guarantees and collateral available to households to borrow from banks. This helps to explain why total domestic credit to the private sector by banks represents less than 50% of GDP in Brazil, a much lower ratio compared with the average of 113.2% of GDP for upper-middle income countries, according to the World Bank. All in all, this means that most of the country's consumption is diverted to goods and services that are less dependent on credit, such as non-durable goods (food and beverages, health and beauty) and semi-durable goods (clothing, household goods and electronic equipment).

Consumption of durable goods, such as automobiles and housing, which are based on lending, seem to have been too dependent on government stimulus in the past. The boom and bust cycle experienced between 2003 and 2014 illustrates these trends. Working through the balance-sheet overhang contributed

to the weak nature of Brazil's recovery in 2017-19 from the 2015-16 recession.

Corporate and household balance sheets are suffering from the current crisis. The Covid-19 crisis will cause a steep decline in GDP. The damage to the public finances, corporate and household balance sheets means that the recovery from this year's recession will be different among regions. The north and north-eastern regions, while comprising 36% of the country's population, represent 23.6% of the national income and almost 20% of GDP, specializing in industrial production of durable and semi-durable (as with the Tax free Industrial Zone of Manaus, capital of the Amazonas in the north) and agriculture and mining (north-east).

The south-eastern region alone accounts for 42% of the population, 51% of income and 53% of GDP, with a very diversified industrial, agricultural and services base, especially in the State of Sao Paulo. The central-west, Brazil's agricultural belt, specializes in livestock, grains (soybean and corn) and cotton, and accounts for 7.7% of the population, 8.5% of income and 10% of GDP. Finally, the south has 14.3% of the population, and mostly specializes in agro-industry. As agriculture will hold up better than industry in 2020, this means that the south and central-west will be hit less hard than other regions.

The current crisis will delay privatization of several state-owned subsidiaries, but parent companies require legislative approval, and this means divestments in 2020-21 will likely be blocked. A partial privatization of state-owned energy firm Eletrobras appears possible. Once a recovery takes hold it is projected that privatizations will continue over 2022-24. Fiscal pressures will likely encourage private capital in infrastructure projects and Brazil's Investment Partnerships Program should advance further with improved legal framework and regulatory agencies. Also, in 2022-24 Brazil's expected OECD accession will likely boost foreign investment inflows.

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