Major Country Risk Developments
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Overview

Surveys of purchasing managers at manufacturers across the U.S., Asia and Europe indicate that the decline in global factory activity is starting to stabilize after the record fall recorded in April. But sentiment remained negative, suggesting that any recovery in the months ahead could be tentative.

The U.S. Institute for Supply Management's manufacturing index for May rose to 43.1 from an 11-year low of 41.5 in April. The index's core components all remained well below the 50 level which marks the threshold between contraction and expansion. A majority of survey respondents confirmed that production and new orders worsened in May from April. The factory indexes add to evidence that the U.S. and other countries might have reached an economic bottom, while recoveries are likely to be slow. Unemployment is up sharply across the globe. Service industries are just starting to recover. And consumer spending, an important catalyst for the U.S. and other economies, remains weak.

U.S. employers unexpectedly added 2.5 million jobs in May, moving the jobless rate down to 13.3% (from 14.7% in April) and easing some fears over the economic hit inflicted by the coronavirus pandemic on the world's largest economy. After more than 20 million lay-offs during the month of April and 1.4 million in March, some of the hardest-hit industries began hiring workers again, including in leisure and hospitality, construction, education, healthcare and retail. Government employment, however suffered 595,000 losses as cash-strapped state and local authorities continued to cut their payrolls.

As protests against racial injustice spread across the U.S., the Department of Labor reported that joblessness among African-Americans continued to rise in May, from 16.7% to 16.8%, even as the overall unemployment rate declined. Things are far from normal in the U.S. labor market, the unemployment rate is still four times the rate in February. However, if the pace of rehiring seen in May is sustained in the second half of 2020 that would provide a major lift to sentiment, thereby enhancing economic recovery prospects.

The non-partisan Congressional Budget Office expects U.S. GDP to contract by 5.6% in the fourth quarter of 2020 from a year earlier, a significant markdown from its 2020 projection of 2.2% growth made at the end of 2019. While the economy is expected to resume some growth in 2021, the pace may not be fast enough to make up for economic declines experienced during the height of the coronavirus pandemic. The Federal Reserve is considering purchasing assets that cap yields on short-term debt, to control borrowing costs, while the gap between the yield on the 10-year Treasury and that of the 30-year is at its widest closing point since November 2016. Bullish investors in U.S. markets appear willing to look beyond some of the biggest civil disturbances in the country in decades. The Nasdaq Composite index is now barely 3% off its all-time closing high.

Even as some Americans are returning to work as states begin to emerge from shutdowns and reboot their operations, some companies are still implementing additional lay-offs; or they are moving to transform temporary furloughs into permanent staff reductions. However, the expanded jobless benefits that were part of the Cares Act are expected to expire in July. The recovery in the labor market is expected to be painfully slow. The pandemic is expected to wipe out a cumulative $15.7 trillion of output from the U.S. economy in this decade, according to the

Congressional Budget Office. Concerns remain that the sporadic looting and vandalism of businesses that broke out of largely peaceful protests against racism and police brutality could further delay reopenings in the U.S. Political and social stability in the U.S. have been dealt a blow. The protests have taken a destructive turn in some cities, and the gatherings may result in further Covid-19 cases and deaths.

Other data highlights the pain in the U.S. economy, as the trade deficit in goods and services widened to $49.4 billion in April, compared with $42.3 billion the previous month. Both U.S. and global trade have already been weakening in recent years, exacerbated by the trade confrontation between Washington and Beijing. Meanwhile, productivity in the U.S. non-farm business sector was revised upwards to show a 0.9% fall in the first quarter, compared with initial estimates for a steeper 2.5% decline.

Benchmark indices in Asia, Europe and the U.S. all moved higher following President Trump's decision to revoke special trade privileges for Hong Kong. The U.S.'s revocation of Hong Kong privileges was in retaliation for Beijing's decision to impose a controversial security law on the former UK colony, but excluded any specific measures against the financial hub. Some believe the phase one trade deal between the U.S. and China may still be safe, for now.

However, **China's** unprecedented steps to crush dissent in Hong Kong are not going to be allowed to go unchallenged by the rest of the world. Some improvement in sentiment in mainland China is supported by data that showed manufacturing activity expanded in May for the first time since January. However, Chinese exporters are enduring a continued collapse in global demand. The gauge for imports and export orders remained in negative territory in May. Companies continued to run down their raw material and finished goods inventories, suggesting a preference for stock depletion rather than ramping up production amid uncertainty about the strength of demand.

In **Brazil** Covid-19 is exacting a huge hit to an economy that was already struggling to recover from recession. The forecast is for the economy to contract by 7.5% in 2020 even with fiscal, monetary and credit measures in place to cushion a deeper blow from disruptions to business activity and consumption. The currency [the real] is expected to remain volatile even after it regained some ground in May, trading at 5.3:U.S.$1. The push for new foreign investment inflows does not appear to be attracting sufficient interest. Governability will be weak as the pandemic and economic crisis rock the political landscape. Meanwhile, President Bolsonaro struggles to fend off investigations into his and his family's activities.

In **Mexico** business confidence in the government of President Andres Lopez Obrador (AMLO) remains weak. While the U.S. will continue to dominate trade flows, there are attempts by Mexico to diversify trade partners. The authorities are seeking stronger investment links with Asia and Latin America to encourage diversification of sources of foreign direct investment. Advanced 4G and 5G mobile connectivity is expanding at a rapid pace. Meanwhile, private participation in the energy sector is expected to show benefits in 2022-24. The government plans on seeking financing for infrastructure investment and is focused on promoting automotive, aerospace and other high-value-added sectors.

Europe

In Europe, a closely watched index of eurozone manufacturers' purchasing activity was slightly better than feared. Nonetheless, the IHS Markit index still showed a significant contraction in orders and output. European equities rose with the Stoxx Europe 600, which lists the region's largest companies, within sight of three-month highs. The yield on 10-year Spanish, Greek and Portuguese government debt fell to their lowest levels since early March, indicating improved confidence in the eurozone periphery. Signs of market optimism are being reinforced by continued lockdown reversals throughout major economies and central banks aggressively cutting interest rates, making available record amounts of liquidity, while Covid-19 cases continue to decline.

Soaring government debt levels threaten to make investors reassess European sovereign risk and could reignite pressures on more vulnerable countries in the region, the European Central Bank has warned. Eurozone governments' budget deficits will rise to 8% of GDP on average this year, far above the levels reached after the 2008 financial crisis, the ECB forecast in its recent biannual financial stability review.

Aggregate government debt is set to rise from 86% of GDP to above 100 per cent across the 19-country bloc as member states seek to tackle the economic impact of the coronavirus crisis, according to the ECB. The financial stability review warns that the pandemic represents a medium-term challenge to the sustainability of public finances. Public debt is set to approach 200% of GDP in Greece and 160% in Italy and will hit 130% in Portugal and just below 120% in France and Spain. The associated increase in public debt levels could also trigger a reassessment of sovereign risk by market participants and reignite pressures on more vulnerable sovereigns.

Italy must refinance more than 15% of its debt in the next year, while that figure is more than 10% for France, Spain, Belgium, Finland and Portugal. The ECB stressed that debt repayments in the coming two years will be substantial for a number of countries in Europe.

A decade ago, economic thinking suggested that beyond 90% of GDP, government debt levels became unsustainable. Although most do not now believe there is such a clear limit, many still think that allowing public debt to build up ever higher would threaten to undermine private-sector spending, creating a drag on growth. Debt levels are rising across the world as countries turn to the capital markets to finance public-sector responses to the economic impact of coronavirus. The OECD club of rich countries forecasts that its members will take on at least $17 trillion of extra public debt as a result of the crisis, increasing average financial liabilities from 109% to 137% of GDP. The ECB, which is due to update its economic forecasts and review its monetary policy, has predicted that the eurozone will suffer its deepest postwar recession this year, with GDP set to contract by between 5% and 12%. It warns that a more severe downturn than expected risks putting public finances on an unsustainable path in already highly indebted countries; this combined with higher government borrowing costs and borrowers' defaults resulting in loan guarantees being called in by lenders.

There is growing concern that the economic contraction in Europe will be deeper than originally thought, hitting hard even stronger economies such as Germany. Eurozone governments are set to issue an expected $2.0 trillion of extra debt this year, although the ECB has positioned itself to soak up a large proportion of that through the $1.52 trillion bond-buying plan it has just approved. A Franco-German proposal to create a $1 trillion European recovery fund would provide grants to support countries hit hardest by the pandemic, offering additional financial help. The ECB touts that the wide-ranging policy measures it has taken have managed to avert a financial meltdown, while stressing that a forceful European-level fiscal response was essential to avoid disparities in national public finances from increasing fragmentation between eurozone countries.

The ECB cautions that although countries' large fiscal policy response is helping to mitigate the economic cost of the coronavirus crisis and provides a first line of defense against fiscal debt sustainability concerns, a more severe and protracted economic downturn could give rise to debt sustainability risks over the medium term. The pandemic risks adding further stress to the eurozone's existing financial vulnerabilities. These include overvalued asset prices, low bank profitability, high sovereign indebtedness, as well as credit risks in the non-bank sector.

South Korea

In May, South Korea's manufacturing sector saw its sharpest decline since the global financial crisis as the coronavirus pandemic hits demand from the country's critical exporters, according to an industry gauge. The IHS Markit purchasing managers index fell to 41.3 in May, a further deterioration from the 50 point marker that separates contraction from expansion and its lowest since early 2009.

Industrial output and new orders continued to sink at rates not seen since the global financial crisis, reflecting global and domestic economic weakness. The export component of the survey also showed another unprecedented monthly decline in overseas demand. The value of South Korea's exports declined by 23.7% in May, at $34.8 billion, compared to $45.7 billion a year earlier. Imports fell by 21.1% to $34.4 billion. The pressure on South Korea's exporters — who usually account for nearly half of the country's GDP — comes despite the government getting international praise for its handling of the public health crisis. Still, health officials reported 35 new Covid-19 infections on June 1, 2020 as new virus clusters in Seoul, the capital, continue to frustrate the government's plans to fully unwind social distancing measures. By the end of May officials had decided to slow the staged return to school for some students and restrict access to some public spaces.

May's trade data marked the third consecutive month of decline in exports. However, the rate of decline in the export sector was slightly better than in April, when exports plunged by more than 25% from a year earlier. Among major export categories, cars and petroleum products remained the worst hit, with overseas sales falling respectively by 70% and 54% year-on-year in May. Meanwhile, the robust growth in shipments of computers continued, on the back of more widespread remote working and online schooling. Exports of semiconductors, the country's top export item, snapped a two-month declining trend and increased by 7.1% in May. The consensus is that the decline in South Korean exports will bottom out in June, as the country's major export markets in Europe and North America start to withdraw or relax containment measures. The resilience in semiconductor exports will likely continue, as global demand for that product has been strong and prices have been trending up all this year.

However, the rising trade tensions between the U.S. and China [two of South Korea's largest trading partners] could pose a grave risk to the recovery of the South Korean export sector.

India

Effective June 1st, India lifted many restrictions that were implemented in March to stop the spread of Covid-19. Despite a rising number of cases Indian authorities proceeded with plans to return to work. The announcement outlined a timetable for the resumption of most activities. Regular interstate movement of people is no longer prohibited, but the movement of people at night is still banned. Effective June 8th, hotels, restaurants, shopping centers and places of worship will be allowed to resume operations (subject to strict hygiene and social distancing standards). The plan calls for schools to reopen in July as part of a second phase of easing.

India's economic growth slowed last quarter, just as the government began locking down a country of 1.3 billion people to contain the coronavirus pandemic. GDP expanded 3.1% in the three months through March from a year ago. That is down from the 4.1% expansion in the previous quarter, while the median forecast in a survey of economists was for growth of 1.6%. Growth was 4.2% in the fiscal year through March 2020, a performance that was in line with the median estimate, but slower than the 5% the government expected before the virus outbreak.

Unemployment has soared because of the lockdown and the government expanded the national employment guarantee scheme. Labor laws are being temporarily liberalized in some provinces.

The services sector, which accounts for 55% of India's GDP, was among the hardest hit by the lockdown restrictions imposed since March 25. Trade, hotels and transport grew 2.6% in the January-March quarter from a year ago, while financial services expanded 2.4%. India was already in the midst of a protracted economic slowdown before the virus hit, as a festering crisis among shadow lenders depressed credit demand as well as spending in the consumption-driven economy.

Private estimates project a larger knock to growth in the second quarter, predicting a 40% decline in annualized quarter-on-quarter GDP, resulting in a record contraction of 5.8% for the full fiscal year through March 2021. The ill effects of the containment measures used to slow the spread of the pandemic and the seeming onset of a global recession are to blame. The rupee is expected to weaken to an annual average of 74.8:US$1 (a 6.3% decline) in 2020 amid safe-haven flows to the U.S. dollar. Together, these trends will have devastating effects on profitability at small and medium- sized businesses, on India's vast informal sector and cause unemployment to spike.

Agriculture output expanded 5.9% last quarter from a year ago. Manufacturing shrank 1.4%. Gross value added -- a key input of GDP that strips out taxes -- grew 3% in January-March quarter from a year ago, compared with an estimate of 1.8% in a Bloomberg survey. The government announced a $277 billion package to help boost the economy, while the central bank has cut interest by a total 115 basis points so far this year. Additional interest rate cuts are expected over the coming months.

The containment measures introduced by the government on March 25th have proven more restrictive than originally anticipated. This has prompted the downgrade of several forecasts. These include the widening of estimates for the 2019/20 budget deficit to the equivalent of 4.5% of GPD from 3.7%, to account for a sharp fall in revenue collection. Now the forecast for the 2020/21 budget deficit has widened to the equivalent of 7.4% of GDP. Merchandise exports will contract owing to disruption caused by the pandemic, but a rebound in exports is expected in 2021 amid a pick-up in global commerce.

The government is expected to take steps toward partial privatization of some state-owned companies in 2021. It also is seeking to liberalize foreign direct investment policies in several sectors; while continuing to encourage the use of locally made products. Over the medium- term foreign investment in export manufacturing is forecast to increase markedly, albeit in a few select regions of the country. In 2020-21 the Reserve Bank of India (the central bank) is expected to relax regulatory norms for debt-laden banks and non-bank financial companies, to incentivize lending to support and stimulate economic growth. Major consolidation and privatizations within the public sector banks will continue. Indian private sector banks now account for a rising share of total lending as bad debt issues persist in public sector banks.

The ruling BJP enjoys a majority in parliament and Prime Minister Modi is expected to retain tight control over the government until 2024. The government continues to push for longstanding structural reforms. But the immediate challenge is the management of the Covid-19 epidemic. Additional fiscal stimulus worth 1.5% of GDP will be forthcoming, as well as a further relaxation of monetary policy.

Chile

The economy is projected to enter recession this year – the first time since the 2009 global financial crisis. GDP is forecast to contract by 4.8% owing to the Covid-19 pandemic. The outbreak is having serious political consequences in a country that has been in the grip of protracted social unrest since protests over economic inequality broke out in October 2019.

Chile is heavily reliant on mining as a driver of growth and is exposed to swings in commodity prices. It is the world's largest copper producer. This make the economy vulnerable to the current global downturn, loss of demand and weakness in capital investments. A recent pickup in demand for copper from China saw prices climb 20% in recent weeks. However, global copper supply is expected to continue to outstrip demand by an estimated 400,000 tons this year – the highest annual demand deficit since the global financial crisis. As a result, copper prices are expected to settle back toward industry norms over the short-term.

The sharp economic downturn projected for 2020 is also a result of a strong negative carryover effect from the last quarter of 2019, when GDP contracted by 4.1% quarter on quarter.

An anticipated recovery (albeit incomplete) in the second half of 2020 should result in a positive carryover in 2021, when GDP is expected to grow by 4.1%. However, the solid growth rate masks the fact that real GDP will not return to 2019 levels until 2022. During 2022-2024 the forecast is for real GDP growth to stabilize at an average of 3.3%. The pandemic is expected to weaken the Chilean peso in 2020, owing to strong investor fears surrounding the country's exposure to global demand. The currency has remained on a downward trend since the start of this year and lost 12% of its value against the dollar by the end of April.

The immediate concern for the government is tackling the health crisis. Policy focus will shift from the social agenda to increasing the capacity of the healthcare system and bolstering the economy more broadly through policy stimulus. Meanwhile, the government faces a turbulent year ahead. Regional and global integration efforts will be placed on the back burner, as the focus is on policies aimed at tackling the pandemic and restoring domestic stability. Trade policy remains at the forefront of the country's foreign policy. Chile has 29 trade agreements in place, covering 65 markets including most of the world's largest economies, including the U.S., China, Canada, the EU, Australia, India, Japan and South Korea. The Chilean government will maintain close ties with its major trade partners (such as China).

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