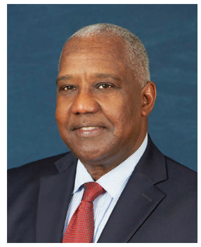
Major Country Risk Developments
July 2019



Global Overview

By Byron Shoulton

A slump in global manufacturing deepened in June, with data from around the world illustrating the extent to which trade tensions are weighing on growth. According to a global manufacturing index produced by JP Morgan and IHS Markit, manufacturing activity fell in June to its lowest level since 2012, with new orders weakening sharply and business optimism falling. Its monthly reading of 49.4, down from 49.8 in May, indicates that a majority of firms reported falling output. Global economic risks appear to have risen, while international investment and trade growth are slowing.

South Korea, often seen as a global bellwether, recorded the biggest year-on-year fall in exports for three and a half years in June. Meanwhile Japan's Tankan index for large manufacturers slipped to its lowest level since 2016, reflecting the slowdown in key Asian export markets. The G20, which represents the world's twenty largest economies, warned of growing risks to the global economy and stressed the need for a free and fair trade environment. Rising concerns about global growth prompted some central banks, such as those in Australia, New Zealand and Russia to cut interest rates.

The U.S. and China agreed to restart stalled trade talks following a meeting between President Trump and President Xi at the G20 summit held in Japan in June. The U.S. agreed to withhold additional tariffs on $300 billion worth of Chinese goods while China said it would buy more U.S. products. While the U.S.-China truce is a positive development for economies around the world, it does not mean that the resumption of talks will lead to a deal between both countries in the immediate future. China says it will open more sectors of its economy, including autos, to foreign investment. China promised that it would liberalize its manufacturing sector and reduced its negative investment list [that restricts foreign investment in certain sectors] from 48 to 40. China asserted that it would also end ownership limits for foreign investors in the financial sector in 2020, a year earlier than planned.

The moves represent a nod to U.S. demands amid the bruising trade war that is beginning to be felt from Asia to Europe. Domestic indicators show activity at China's factories is slowing while domestic demand has been weak. China's National Bureau of Statistics confirmed that the purchasing managers' index for June registered 49.4, the second lowest result since June 2016. A reading below 50 suggests a contraction. The data is a clear indication that China's industrial sector is struggling. The consensus is that private Chinese based companies, especially smaller firms that are more export-oriented, will continue to see slower export orders amid weak global trade and the continuing dispute between the U.S. and China.

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Meanwhile, the U.S. economy created 224,000 new jobs in June surprising on the upside following weak jobs growth reported during the prior month. The consensus is that the U.S. economy retains some momentum [ten years after the great recession and the financial sector meltdown], evidenced by continued solid job creation in manufacturing, services and mining; and backed by sustained advances in the equity markets during the first half of 2019. Furthermore, continued low inflation, capital inflows and still relatively strong consumer sentiment supports the

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outlook for GDP growth averaging 2.2% over the remainder of 2019. Markets are closely watching the Federal Reserve for clues about the course of monetary policy over the coming months. If the central bank cuts interest rates, some are expecting lower borrowing costs to provide a boost to the economy and help to sustain the stock market rally through the second half. Nonetheless, it appears that the Fed has pivoted from raising interest rates to lowering them once again.

Still, uncertainty over U.S. trade policy could weaken business sentiment and chill investment, raising new risks for an otherwise stable U.S. economy.

Mexico's central bank decided to maintain its current policy interest rate of 8.25% late in June stating its ongoing concerns over the state of the global economy, which is estimated to have weakened in the second quarter of this year. On the domestic side the central bank highlighted the state of financial volatility particularly following the threat of U.S. tariffs in late May (which were subsequently withdrawn when Mexico acted to slow the flow of migrants crossing over to reach the U.S.). The bank positively noted a slight uptick in Mexican economic activity as well as a reduction of inflation to 4% in June. The decision to retain the policy rate at 8.25% suggests that the central bank concluded that the upside and downside risks to growth are more or less equal.

Costa Rica

The current economic landscape in Costa Rica has become less favorable than projected at the beginning of the year. The IMF lowered its 2019 growth outlook for Costa Rica from 3.3% to 2.8%. Most independent forecasts put production well below the central bank's optimistic projections of 3.4%. Actual figures show GDP growth during the first quarter 2019 was 1.8% (compared to 3.3% registered during the same period in 2018). The slowdown represents internal and external factors such as the weakening of economic activity in major trading partners, a fall in exports, economic turmoil in Nicaragua, and lower levels of consumer and business confidence.

GDP growth in the first quarter was driven by higher external demand for both goods and by private consumption. The demand for services expanded by 3.6%, driven by sales of medical equipment, which were offset by a fall in sales of some fruits. Growth in services were a result of inflows of tourists and business services. Falling sales of vehicles, building materials and electronic appliances has been a drag on general commercial activity since November 2018. The monthly index of commercial activity, which measures sales of goods in 23 product groupings, has dipped each month since then. The slowdown in the construction sector highlights the general uncertainty hitting the economy, including the implementation of a new value added tax. Some recovery is expected during the third quarter of 2019, which should also have a positive impact of sales of electronic appliances.

High unemployment and the government's low approval ratings are limiting the formulation of pragmatic economic policies. Unemployment in recent years has trended between 9.1% and 11.3% [the rate reported for the first quarter]. The lack of opportunities has weighed on public opinion: only 27% of Costa Ricans approve of the sitting president, while only 8% had a positive outlook of the country's economic direction. The labor market is forecast to remain weak over the next few years as fiscal reforms limit public sector hiring and domestic demand.

Costa Rica's legislative system also prevents the swift passage of bills, as a single legislator can typically block a vote for months at a time. President Carlos Alvarado is pushing for more progressive energy and social policies and has emerged as one of the more vocal heads of state to advocate for adopting renewable energy and limiting his country's carbon footprint. He has pushed for tax credits for electric vehicle purchases and increasing the amount of hydrogen-powered buses on the roads. President Alvarado is continuing to build a political consensus around economic reforms to reduce the country's high fiscal deficit (currently at 5.8% of GDP) over the next several months.

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The economic slowdown remains a challenge. The hardest hit industries are trade and agriculture. Road blockades, linked to students and transport firms, all supported by unions, started June 27th and worsened over the weekend of June 29-30. The protests are linked to a number of topics including public employment legislation and the exit of the Minister of Education. The protests have impacted tourism as well as exports, with estimated losses of $12 million for the latter, as some 1,000 containers have been trapped, unable to leave or reach ports. The National Chamber of Dairy Farmers has estimated losses of 576,000 kilos of milk per day, due to the roadblocks which prevented the transport of milk from the northern region, where 60% of the country's milk is produced. The losses to dairy farmers over the four days were estimated at $1.7 million. Dairy farmers, among others, were also prevented from bringing in vital supplies due to the protests.

Since March 2019, the central bank has cut its policy interest rates three times by 25 basis points to stimulate economic growth, and it now stands at 4.5%. Weak economic activity and the high unemployment rate prompted the rate cuts and for this reason the expectation is that the monetary authority will maintain a loose monetary policy stance over the near term. In annual terms, GDP growth is expected to remain subdued at around 2.6% in 2019 and 2.5% in 2020; whereas headline inflation is projected at 3.2% by year-end 2019 and 2.8% at year-end 2020.

Costa Rica will strengthen its fiscal sustainability by controlling expenditure and modernizing the tax system with a $350 million loan approved by the Inter-American Development Bank (IDB). The objective of the project is to approve legal instruments of fiscal policy and management that reinforce sustainability and efficiency, both on the expenditure side and on the revenue side. This will include the approval of a fiscal rule to control spending and a proposal for the design of an Independent Fiscal Council. It is hoped that these measures will boost GDP up to 3.8% by 2023, including 1.7% linked to higher tax revenues and 2.1% from current expenditure savings.

The IDB loan, for $350 million, has a repayment period of 20 years and a five and half year grace period. Separately, the Development Bank of Latin America (CAF) approved a line of credit for $500 million for Costa Rica's financing needs and the country's Legislative Assembly approved a placement of $1.5 billion in Eurobonds. Proceeds from the bond sale will be used to replace debt bearing higher interest rates.

Nicaragua

Since April 2018, President Daniel Ortega's government has conducted a systematic campaign of repression and state-sponsored violence against public protests and the activities of Nicaraguan opposition groups. Negotiations between the government and the opposition Alliance for Civil Justice and Democracy (ACJD) are unlikely to be successful; while growing economic pressure raises the risk of fractures developing within Ortega's Sandinista Liberation Front (FSLN). Attempts at dialogue in March and May 2019 both failed due to the government's unwillingness to move elections forward or to release all political prisoners by a June 2019 deadline. The failures stem from mutual distrust, as the ACJD has accused President Ortega of using the negotiations to buy time and divide the opposition. Ortega claims the opposition is attempting to stage an illegitimate coup. Estimates are that approximately 595 people have died at the hands of the police and paramilitaries since the political crisis erupted last year.

According to the Federation of Central American Chambers of Commerce intra-regional trade fell by 24% between April 2018 and April 2019 owing in large part to the political crisis in Nicaragua. Violent demonstrations and highway blockades curtailed road freight flows, which account for roughly 80% of total regional trade. With Honduras, El Salvador and Guatemala in the north of Central America, and Costa Rica and Panama in the south, Nicaragua acts as a key over-land transit route for the region as a whole. As a result, several companies were forced to use maritime trade routes in order to circumvent Nicaragua. Even though levels of violence have fallen and the road networks running through Nicaragua are now clear, the political crisis precipitated a domestic economic crisis, which sustained weak trade flows.

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Although trade flows normalized in the fourth quarter of 2018, new problems loomed in mid-March of this year when the Nicaraguan government started levying a charge of $50 on every Costa Rican truck entering its territory, irrespective of the ultimate destination of the cargo. The Nicaraguan government argues that the charge is in response to Costa Rica's own customs fees (which Nicaraguan authorities allege can be as high as $236 per truck). Both countries are in talks to resolve the dispute, but a resolution is not assured. In the meantime, higher costs for transportation and longer delays at border posts will continue to dampen intra-regional trade. According to a report released by the association of private industries in Nicaragua, Cosep, the domestic banking sector saw an overall plunge in deposits of 33% between March 2018 and May 2019. The banking sector loan portfolio fell 24.6% in the same period. The ongoing social and political crisis which began in April 2018 continues to have a serious negative impact on the country's banking sector and has hurt overall confidence. Reports of slow payments and or defaults by Nicaraguan entities have grown as a result. Some 62,000 Nicaraguans have reportedly fled the country during this period. However, the government of Nicaragua has prevented the migration of children and adolescents.

The resilience of gold production in Nicaragua – despite the ongoing political crisis- is a source of comfort to that sector. Contrary to other countries of the region, Nicaragua openly encourages mining activity. The Nicaraguan government claims it has over 71,000 square kilometers of land available for mining concessions. Currently, 10,000 square kilometers are under concessions, while projects in another 1,500 will soon be online. Gold mining has attracted investment from numerous multinationals, including Canadian, Colombian and British firms. Gold accounted for 15% of Nicaraguan exports in 2018. An important reason behind the strength of the mining sector is the low population density, meaning that mining projects are, on average, less likely to affect local communities. Mining was affected by the ongoing political crisis; however, companies continued with their operations and production has now normalized.

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The recent tactics of the Ortega regime suggest that the government has no intention of compromising or giving up power before the end of its term in 2022. This was underlined by the ruling party's decision to pass an amnesty law forgiving crimes committed during the April 2018 unrest, which critics regard as a way to whitewash government repression, as well as its refusal to release roughly 80 people being held as political prisoners. Another 600 opposition supporters were released from jail recently but are being held under house arrest.

An opposition-led national strike went into effect on May 22, 2019 signaling that the ACJD has lost faith in negotiations under the current conditions. The conclusion is that negotiations alone will not be sufficient to end the current Nicaraguan crisis.

Any further deterioration in economic conditions will increase the likelihood of splits developing in the regime. Pressure has grown from two primary sources. First, the economy is forecast to contract by 7.2% this year, as political uncertainty and a sharp reduction in credit take their toll. This is combined with increased repression to sever the government's close ties with the business sector. The split between the ruling party and business was reflected in the national strike, which reportedly had strong support across the country. The government threatened to sanction banks that participated in the opposition's national strike, and reportedly closed several businesses that did participate, underscoring the break in the previously cozy relationship between Ortega and the private sector.

Second, international pressure on the Ortega regime has grown slowly. In June the Organization of American States (OAS) demanded that Nicaragua release all imprisoned opponents of the government, cancel legal cases against them and restore fundamental rights in the country. Nicaragua was expelled from the organization.

The U.S. and Canadian governments imposed sanctions on key Nicaraguan government officials, tying them to a tough crackdown on the street demonstrations that began in April 2018. The U.S. said the sanctions were meant to send a message to President Ortega and his inner circle that the U.S. Administration is standing with the Nicaraguan people in their calls for reform and a return to democracy. The U.S. also passed the Nicaragua Human Rights and Anticorruption ACT (NHRAA), which cuts off most multilateral loans to the country. Sanctions also targeted the state-run Bancorp, which has since been closed. Future sanctions on exports to or remittances from the U.S. could further destabilize the Nicaraguan economy.

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The measures imposed by the U.S. and Canada include asset freezes and prohibitions of any dealings with senior members of the Nicaraguan government, including the president of the Nicaraguan National Assembly, which operates as a rubber stamp machine for the Ortega regime. The European Parliament has also been highly critical of the Nicaraguan government, warning that sanctions on the regime may be forthcoming shortly. The growing pressure could lead to Ortega losing support among the country's political elite and the security forces. President Ortega's continued hold on power relies on his ability to mobilize the security forces to repress protesters, while using government institutions such as the national assembly and the National Electoral Council to cripple efforts to challenge the regime through formal channels. If this support starts to wane due to internal and external economic pressure, a plausible scenario is that President Ortega will be forced back to the negotiating table in a significantly weakened position, leading to the full release of all political prisoners and early elections.

Last year's sanctions against President Ortega's wife (who is also the vice president), son and the national police chief did force the president's hand, making it clear that he had to take steps to alleviate Nicaragua's plight. As a result, he agreed to reopen the stalled talks with the opposition earlier this year. The release of Nicaragua's political prisoners, albeit marred by their continuing legal limbo, is a pragmatic outcome of these debates. They show that international pressure can have an impact.

However, there are no clear signals of high level defections so far as a result of international sanctions. Moreover, the opposition is relatively weak and disorganized; plus, Ortega's ability to rely on informal 'paramilitary' groups reduces his dependency on the military to repress protests. The supposition is that Ortega has the ability to put together sufficient resources to fund the patronage system which allows him to stay in power, despite the country's growing economic recession. He could possibly stay in power through the end of his term in 2022.

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FCIA's Deals Of the Month

Bank Non-Cancelable Limit Policy: $20 million limit for short term import financing in Argentina in the petroleum industry.

Key Account Non-Cancelable Limits Policy: Covering $27 million of sales of industrial chemicals primarily to buyers in the US. Policy was obtained to enable the insured to offer more competitive terms to their customers.

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**   **Non-Cancelable Limits:** Subject to policy terms and conditions, after issuing the policy, the insurer may not unilaterally reduce any country or buyer limits.*