Major Country Risk Developments
January 2020

Overview

There are important challenges facing the global economy in 2020. Slower growth has become a dominant theme across Europe, Latin America and the Middle East; manufacturing activity has weakened; while growing geopolitical conflicts, nationalism, anti-globalization and protectionist trends underscore sentiments of continued uncertainty.

The U.S.-Iranian relationship moved further down a negative path. The possibility of open confrontation between both countries heightened suddenly after the U.S. assassinated a high profile Iranian general. The deceased general was believed to be the second most important member of the ruling Iranian regime and the architect of Iran’s regional military strategy over the past two decades. The unprecedented U.S. action is interpreted as not only hostile, but to some it is considered an act of war. Iran’s immediate retaliation seemed tempered given the scope of the damage the general’s demise has done to Iran’s image. This has led to a consensus that neither Iran or the U.S. want to become engaged in a war at this time. Any further escalation would undermine regional security and act as a further destabilizing force – in an already unstable region.

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The U.S.-China trade conflict has been placed on somewhat of a temporary hold, with the pending modest “Phase 1” interim agreement, which is scheduled to be signed by both countries shortly. The accord will give both sides a chance to reassess their respective positions, while they continue trade with each other, albeit at a reduced pace. The U.S. agreed to hold-off on implementing additional tariffs and agreed to cut in half the existing15% tariff rate on roughly $120 billion of Chinese goods. China wants existing tariffs rolled back.

The U.S. expects substantial concessions from China, including opening-up its financial markets to U.S. companies; protecting U.S. intellectual property rights and dropping the requirement for U.S. companies to transfer technological knowhow in exchange for access to the Chinese market. However, there are still no commitments from China to these specific demands. Neither is there a Chinese commitment to the purchase of a set dollar value of U.S. agricultural goods over the coming years, despite a U.S. insistence that China will buy up to $50 billion of U.S. ag products each year.

Trade disagreements aside, the intense rivalry between China and the U.S. and the level of distrust that it sparked, have the earmarks of a deep seated conflict with the potential to eventually reshape the relationship between the world’s two largest economies. The conflict is likely to alter many previously held assumptions, as each side distances itself from the other in an attempt to protect perceived national interests. At the root, it appears that both sides want to weaken the other’s global influence, reduce the risk of economic sabotage and protect itself from possible security threats (including cyber warfare). Accomplishing these goals will involve a series of complex calculations as both country’s economies are already deeply entangled.

By Byron Shoulton
Brazil

Brazil has survived its first full year under the leadership of President Jair Bolsonaro, a right-leaning pro-military populist. The economy has shown some improvement under the new administration, but lots still need to be done to get Brazil back on track as a leading growth economy. The approval of pension reform in October and other fiscal adjustments are projected to help stop the rise of the public debt (currently 79% of GDP) over the medium term. The Bolsonaro government is expected to pursue free-market and socially conservative policies over the remainder of its four-year term which ends in December 2022. Bolsonaro’s chance of re-election will hinge on the strength of the economy then.

GDP growth is expected to pick up from an estimated 1.2% in 2019 to an annual average of 2.3% in 2020-24. These projections are upward revisions which came as a result of the pension reform approval last October. The ruling party is governing without a formal alliance. While the government’s economic agenda is supported by centrist parties, many of its socially conservative policies will be blocked from passage. The release from prison of former president Luiz Inacio Lula da Silva (2003-10) will energize the leftist opposition.

The expectation is that piecemeal progress on the next phase of economic reforms (including budget flexibility, tax simplification and administrative reform) will begin to take effect in 2020. Trade liberalization and progress on the privatizations of several state-owned entities will support the economic upturn.

The central bank is expected to end its easing cycle with a final Selic policy rate cut, to 4.25% in February, before a tightening cycle is expected to begin in 2021. Recession and a weaker currency have led to import compression, supporting trade surpluses in recent years. The current-account deficit is estimated at 2.4% of GDP for 2019, which is modest but likely rise over 2020. The unemployment rate remains high and the government plans to implement additional measures to reduce labor costs.

Regional exporters ended 2019 with a flourish after their weakened currencies boosted FX earnings and triggered a surge in production of certain commodities including sugar, coffee and copper. Economic problems and social unrest across the region have combined to hammer exchange rates. The Brazilian real and Chilean peso hit record lows in November, forcing the countries’ central banks to sell dollars to prop up their currencies. This could continue into 2020 but economic recovery will bolster the real. Lower interest rates and softer terms of trade mean that the currency will avoid becoming overvalued as it has in the past. The currency is forecast to weaken to R4:$1 by end-2024, as it adjusts to a wider current account deficit.

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Most commodities are priced in U.S. dollars, so a decline in the exchange rates of regional currencies means local producers are enjoying higher prices in local currency terms. Brazilian farmers, for example, were saved the pain of a recent slump in sugar and coffee prices by a weaker real—down 6% against the dollar last year. This makes Brazilian commodities (sugar, soy, coffee) in theory more attractive. The Brazilian real’s devaluation compensated for movement in the international price. The weaker real could have knock-on effect on ethanol, which is also made from sugar cane. With better returns for sugar sold to international markets, mills might shift away from earmarking cane for ethanol which is used to blend gasoline locally. Production in the last harvest was skewed towards ethanol due to depressed global sugar prices.
Meanwhile, Brazil’s financial system remains strong and liquid. Central bank reforms are slated to improve efficiencies and competitiveness within the sector and should help reduce borrowing costs. Monetary easing and low inflation over the next year should support gradual increases in bank lending.

With an anti-globalist orientation, Mr. Bolsonaro’s presidency has changed the direction of Brazilian foreign policy. Policy is now framed as an antithesis of that of the previous Workers Party government’s approach, which curried favor with ideologically aligned leftist countries in the region. Instead, policy will now be generally more pro-western and, in particular, more closely aligned with the U.S. (at least while President Trump remains in office).

The gradual economic recovery will likely lift imports in 2020, narrowing the structural trade surplus (owing largely to agricultural exports) and widening the current-account deficit. Foreign direct investment is forecast to average 3.2% of GDP over the coming years due to sizeable market opportunities. Over the next year 5G frequencies are to be auctioned off, with the expectation that the quality of communications will rise as demand expands for these services. By 2022-24 the building of 5G infrastructure network is expected to begin and be rolled-out to consumers.

France

The French economy held up better than some of its regional peers in 2019, with estimated GDP growth of 1.3%, well above the 0.5% expansion expected in Germany. In part, this reflects the larger domestic sector in France, which insulates the economy to some degree from the global manufacturing slowdown. It also reflects the effect of tax concessions made to the “yellow shirt” protesters, which helped support consumer purchasing power in 2019. This momentum is expected to be broadly maintained during 2020, with job creation remaining robust, as the reforms to the labor market made in 2017 are now bearing fruit. The forecast for GDP growth in 2020 is again 1.3%, with still modest trade growth holding back export volumes.

A transport and public sector lockdown resulting from strikes by labor unions has hit the economy and is creating havoc for French citizens and tourists alike. The lockdown has further hurt President Macron’s popularity as he faces the fury of French workers and inconvenienced commuters. In addition, negotiations continue between the government and trade unions over a contentious pension reform bill, while national industrial action against the reform bill has now lasted over six consecutive weeks. This is a delicate balancing act, with both sides standing their ground, hoping that the other will yield with concessions.

French unions remain resolutely opposed to a controversial “pivot age” contained in the pension reform bill (which would mean that retirees would only be able to draw a full pension at age 64, versus 62 currently). The planned removal of so-called “special regimes” that allow workers in some sectors to retire early, at 52 or 57 is also considered non-negotiable by the unions. With more than 60% of workers still supporting the strikes, there’s growing pressure on the government to compromise. There appears to be some movement on the part of the government to give up on parts of the reform effort, with the French Prime Minister recently stating that no aspects of the reform proposals are fixed. The impasse will not continue indefinitely, as the government needs to reach an agreement with the unions before the nationwide municipal elections, which are due in March. The government needs a successful resolution to pension reform, to avoid political embarrassment - if it were forced to abandon a bill that it has spent so much time crafting.

Generally, there is some doubt that further reforms will go forward in 2020, due mostly to the French propensity for protests. Even if protests eventually die down over pension reform, the government is expected to proceed cautiously with additional reforms. Instead, the focus will shift early in 2020 to
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the nationwide municipal elections that will elect some 35,000 mayors. Mayors are the most trusted elected officials in France, and elections are held every six years. This vote will be a major indicator of the level of public support for the different parties across the country, and the degree to which the ruling party has succeeded in gaining local roots. Macron’s party, La Republique en march (LRM) is a relatively new entity so there is keen interest about how it will perform against the growing influence of the French far-right and nationalist parties.

Ongoing trade tensions with the U.S. will be a key issue in 2020. Although the deadline for the U.S. to impose tariffs on EU automobile exports passed without incident, the U.S. has imposed tariffs on a range of EU goods over a dispute involving Airbus. It has threatened further tariffs on France specifically over its digital services tax, as well as a Section 301 investigation of EU goods exports more broadly. Further tariff hikes would be risky for the U.S. Administration in an election year but cannot be ruled out. Tensions with the U.S. could also be raised by the French decision not to exclude the Chinese telecommunications firm, Huawei, from its 5G spectrum sales in 2020.

On the European stage, France will be well placed to set the agenda in 2020. The UK will remain focused on Brexit, leaving the EU on January 31, 2020, but occupied with trade negotiations thereafter. Ever since his election in 2017 President Macron has been pushing for change in the EU. Initial efforts to re-energize the French-German alliance fell flat, and more recently Macron has been pursuing a more independent foreign policy, disconcerting allies in the EU by making unilateral pronouncements on controversial topics. This is a far cry from the consensus-building approach that the EU as a block usually follows. It has caused some collateral damage, but it has also managed to spark substantive debates about the future of NATO and the EU. The question of how Europe can ensure its strategic autonomy in a world where the U.S. is a less reliable partner and China a fast-growing “systemic rival” will be hotly debated in 2020. President Macron seems likely to play the role of mediator in the souring Middle East relations with the West.

Germany

The economy has flirted with recession over most of 2019 (GDP growth estimated at 0.6%) and enters 2020 no stronger. While weakened global demand has hurt German exports [e.g. to China], Germany’s high savings rate and perceived underinvestment in infrastructure and housing dampened growth prospects. Domestic demand together with the global slowdown has generally slowed sales in retail and services. The slowdown reflects an industrial downturn, triggered by external factors and changes in the auto industry. There has been a noticeable slowdown in German exports to China, in line with slowing Chinese economic growth and the intensifying U.S.-China trade war. However, German exports to other significant trading partners have also been declining since late 2018. Exports to the UK have been hit by Brexit uncertainty, and Sweden and Turkey are also experiencing a downturn. The automotive sector is also facing challenges. Global car sales have declined in 2018-19 reflecting slowing demand from China and structural shifts in the industry.

Germany’s current-account surpluses are large by international standards, having averaged 8.4% of GDP in 2015-17. They are underpinned by huge trade surpluses, reflecting the competitiveness of its manufacturing sector. This will continue to generate large domestic savings that are mainly invested abroad, leading to a solid primary income surplus. Forecasts are for current-account surpluses to remain broadly
stable, at an average of 7.1% of GDP in 2020-24, from an estimated 7.3% in 2019.

Investment spending by the German state and private sector must increase over the medium term to create needed GDP growth momentum that would prompt new opportunities for economic recovery over 2020-22. The current slowdown is likely to persist over the first half 2020; but could begin to pick up steam after a kick-start in mid-year 2020. Several European countries are also seeking new ways to spur exports and fresh domestic consumption.

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Meanwhile, Germany faces leadership challenges with the imminent departure of longtime Chancellor Angela Merkel. The question of who will lead Europe’s largest economy after Ms. Merkel steps down is most likely at the top of the EU agenda. What economic policies and global relationships will the new German leadership pursue is a second important question that’s swirling. What changes will these represent for the German economy going forward and what are the implications vis-à-vis the future of the EU?

Germany has played a central role in designing and leading European institutions. Some say German influence in the region will not wane significantly after the “Merkel era”. This especially in the case of its economic dominance in the EU and the fact that the former German minister of defense, is now the European Commission president. Germany’s lukewarm support for France’s eurozone reform proposals-and Germany’s goal of redesigning security and refugee policy- are unlikely to change. The French-German alliance will likely experience frictions on the debate about Europe’s future, but they will remain fundamentally strong.

It is now necessary for German policymakers to contemplate some level of government sponsored stimulation to restore the economy on a sustainable growth path. This is tilted in the direction of greater spending (infrastructure, etc.,) and less savings. The use of public-private joint-ventures to encourage large scale infrastructure projects is one approach that should be fully explored. Forthright investment strategies that boost manufacturing, research and investment in new technologies are likely to gain momentum in the search for renewed growth. Investment in new technologies is considered a long-term necessity to keep the German goods & services sector globally competitive.

The ascendency and strength of right-wing political parties across Europe is being carefully watched to assess their potential to be in leadership- new decade. It appears that in Germany [as in many other European countries], nationalistic, anti-immigration biases, could increasingly influence social policy. Meanwhile, the German workplace is increasingly in greater need of foreign skilled workers to fill jobs.

The euro has been on a declining trend against the dollar since it peaked at u.s.$1.23:EUR1 in February 2018. This reflects the divergent monetary policy stances of the European Central Bank and the U.S Federal Reserve, and weaker growth in the eurozone. The threat of U.S. tariffs on EU automotive exports and a disorderly Brexit have also weighed on the currency.

What role will Germany play in the future EU (if it sustains), and how will German input influence relations between East-West and the Middle East, are questions that will be repeatedly examined over the next few years as the EU seek to remain intact and stay globally relevant.

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Taiwan

Taiwan outperformed expectations in 2019. Still, the territory’s risk rating has been consistently deteriorating over the last year, causing some investors to be cautious, despite the prospect of further solid gains.

The Taiwanese dollar has strengthened, government bond yields hit record lows and equities have been on a roll, pumped up by solid capital inflows. Mainly this reflects the fact that Taiwan has benefited from the China-U.S. trade war, as firms seek out a suitable alternative manufacturing base to avoid having to pay punitive import tariffs. Taiwan is well placed to benefit from this. As a leading manufacturer of high-tech products such as laptops, tablets, graphic cards, screens and microchips, including those used for smartphones – Taiwan thrives on technological change influencing market trends. The new Apple iPhone 11 is playing an important role supporting manufacturing along the product chain, and the new 5G infrastructure is set to provide another leg-up for the coming years.

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Consequently, the Taiwanese economy is benefiting from the growth of exports. Real GDP growth was 2.9% year-on-year in the third and fourth quarters of 2019, bolstered by this onshoring effect and renewed demand for electronics. Overall GDP growth is expected to exceed 3% in 2019 and 2020. This is supported by increased liquidity from global central banks providing monetary policy stimulus, and the government’s outward looking Southeast Asia policy, attracting tourism from the region to compensate for China imposing travel restrictions.

Taiwan has low inflation, few fiscal problems, a current account surplus and low unemployment. However, creditors and investors must guard against expecting the good times to continue indefinitely. The economy is in decent shape compared with other emerging markets in Asia that are struggling. However, Taiwan has its own peculiar political risks to consider, which includes the upcoming January 2020 elections. President Tsai Ing-wen is likely to be returned for a second term given higher approval ratings, linked to the strong economy and the Hong Kong crisis which is making Taiwanese citizens more wary of Chinese influence.

President Tsai has rejected China’s “one county, two systems” approach, and Beijing’s unwillingness to negotiate its way out of the Hong Kong crisis amply demonstrates to many why they must keep faith with an independent leader. President Tsai is well ahead of her closest challenger Han Kuo-yu- who is running on the pro-China Kuomintang (KMT) ticket – but that lead possibly reflects the fact his campaign has been beset by problems. Tsai’s Democratic Progressive Party (DPP) is only narrowly ahead, signaling there is some prospect of tension between the executive and legislature, should the smaller political parties hold the balance of power.

India

India is a nation in crisis as Prime Minister Modi appears to have emboldened a sea of opposition to his campaign to transform the country into a Hindu state. The Modi government is accused of stoking racism and religious bigotry with its new definition of Indian citizenship.

Meanwhile, the economy struggles to attract much needed foreign investment. GDP growth has settled at 4.5% over the three most recent quarters (down from 7.4% GDP growth two years ago). Fiscal constraints and inflationary pressures will preclude
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implementing fiscal and monetary stimulus measures over the short-term. Meanwhile, emboldened opposition controlled state governments are expected to obstruct the progress of major projects backed by the central government, further undermining India’s growth potential in 2020-22.

The government has reacted defensively to the drumbeat of poor economic data in recent months, lashing out at critics and questioning the basis of some reports. In response to criticism from prominent businesspeople over the state of the economy, the finance minister warned that such rhetoric could harm India’s national interest. Officials scrapped a recent government survey that showed an unprecedented decline in consumer spending in recent years, arguing that the methodology was flawed. The consensus is that rather than responding robustly to the current economic slowdown, Prime Minister Modi and the ruling BJP are likely to remain focused on divisive social issues that they believe will pay political dividends.

Indians flooded the streets in cities and towns across the country in recent weeks, to protest a controversial new citizenship law. They have marched in droves despite the imposition of colonial-era prohibitory orders aimed at preventing public assembly. The agitation started in dozens of universities across India, provoking a violent crackdown by the government and the detention of thousands. Nevertheless, demonstrations still spread, giving rise to one of the largest pan-India protest movements the country has seen in several decades. Though the government has resorted to shutting down Internet and mobile service in several areas (including New Delhi), it has been unable to contain the sheer scale of the protests.

Since Prime Minister Modi’s re-election in May 2019, the Hindu nationalist government has pursued a more strident and divisive series of policy measures, including stripping Kashmir of its semi-autonomous status. In addition, Modi’s government has become more authoritarian, leading India’s normally reticent business community to complain of a contentious and toxic atmosphere brewing in the country. The seemingly benign Citizenship Amendment Act, passed by the Indian Parliament on December 11, 2019 appears to have been one step too far. According to the new law, members of minority groups—Hindus, Sikhs, Buddhists, Christians, et al, [from Afghanistan, Bangladesh, Pakistan, etc.,] who came to India illegally, will now be granted a fast track to Indian citizenship. But through this simple provision, the government has also redefined Indian national identity in terms of religion and spawned a crisis for India’s secular constitution. For the first time since India’s constitution was adopted in 1949, Parliament has explicitly linked religious identity to citizenship.

The act seeks to redefine Indian national identity, moving the country emphatically in the direction of being an ethnocracy. India is only a Hindu nation in the sense that a majority of its inhabitants are classed as Hindu. However, it also has the second-largest population of Muslims in the world and a significant presence of almost every other religion. Until now, India has never defined its identity in terms of religion or ethnicity. However, Hindu nationalists have long wanted to remake India as a homeland for Hindus, embracing an idea of nationhood similar to the Israeli model.

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The Citizenship Act, by excluding Muslims, takes a step in that direction. Some analysts conclude that the new law creates a legally sanctioned system of discrimination, one that is an affront to India's secular democracy. Growing opposition to the citizenship act may be a refreshing sign of possible constitutional regeneration among India's populace. But the growing movement could struggle against the headwinds of PM Modi's assertive Hindu nationalist fervor. The ruling BJP policy priorities in recent months reflect a hard ideological turn; which leaves prospective investors and creditors unsure about the future and more restrained toward the market than they would otherwise be.

The ongoing protests have the potential to plunge India into a deep crisis. Already the state appears to be using its arsenal of prohibitory orders to contain legitimate protests. The scale of the suppression of dissent is extraordinary but those opposing the shift away from a secular India are not likely to give up easily. Therein lies the seed of doubt that India under President Modi would become a second China in the making. India as a Hindu state begs the question: Is being a Hindu state an attractive designation that is likely to increase investment flows into India? Will Prime Minister Modi’s ongoing push toward Hindu nationalism, destroy India’s dream for economic development over the next decade; or will it destroy Modi’s legacy?

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