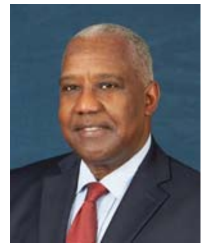
Major Country Developments
January 2017



By Byron Shoulton

Overview

Global economic growth is projected to increase slightly to 3.4%-3.5% on the back of ongoing recoveries in a number of emerging economies including Russia and Brazil. There are signs of continued pick-up in momentum stemming from improved financial conditions globally. Even while still in the midst of a decade long slow growth environment, the improvement projected in 2017 rests mainly on assumptions that the global economy will be bolstered by ongoing recovery in developed economies and by stronger activity in emerging nations, particularly in the energy-rich Gulf Cooperation Council region.

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That said, several geopolitical factors will contribute to a highly uncertain environment. The global economy confronts several possible realignments as we enter 2017. Changes in existing trade and regional arrangements seem likely to unfold. The most obvious is the incoming Trump Administration in the U.S. and many unknowns over how president-elect Trump's campaign pledges will be implemented and their likely effects on trade and future global relationships. These include the future of the NAFTA trade agreement among the U.S., Canada and Mexico; U.S.-Chinese trade and strategic relationships; a realignment of the U.S.-Russian trade and strategic relationships including lifting of sanctions against Russian interests; the U.S. role in NATO vis-à-vis funding of that military alliance and similarly the U.S.-Japanese and South Korean strategic relationships. There will be much to negotiate and diplomacy will have to play a role. All parties will be seeking to secure a better deal for their respective countries and to protect their best interests. It is clear that the incoming Trump Administration will not be pursuing a business as usual approach on several of these issues.

In some cases a more confrontational approach seems inevitable [e.g. U.S. willingness to label China a currency manipulator and charging the country with dumping steel on global markets at below production costs, making it impossible for U.S. steel producers to compete]. Even in confrontational situations it is possible for countries to find common ground and to negotiate solutions that ease tensions, provided there is a mutual desire to reach agreement. One tricky construct is the tendency of using the threat of imposing tariffs on a country's imports even before negotiations begin. While useful as a tactic in getting parties to pay attention, it is not necessarily a game changer. In the case of imposing stiff tariffs against certain Chinese imports, studies have shown that even with higher tariffs Chinese producers are still able to sell products abroad at cheaper prices.

U.S. consumer confidence is up at 13-year highs with improved expectations for GDP growth over the coming year. U.S. factory activity accelerated in December at its strongest pace in two years supported by continued momentum in manufacturing, a pick-up in export orders and a strengthening jobs market. Despite the strong dollar, export volumes rose at their fastest pace in 17 months. The Institute for Supply Management has signaled expansion in nine of the past ten months. Growth has been more robust in the service industries, which accounts for the bulk of U.S. employment and economic output. The Trump election has revved up hopes of business-friendly policies, lower taxes and expectations of easier business regulations – all of which helped in boosting business confidence. The outlook is for continued broad GDP expansion of 2.6%-2.9% in 2017, averaging 3% over the next 18 months. Going into the New Year the basis appears set for a pick-up in U.S. investments, hiring and increased production to satisfy an uptick in momentum in both domestic and global demand for U.S. goods and services. Other factors boosting consumer confidence are the rising equity markets, stable gasoline prices and a modest pick-up in wage growth. Nonetheless, the continued strength of the dollar will in certain instances hamper U.S. companies from competing successfully abroad and hurt foreign earnings of U.S. multinationals.

Meanwhile, the future of the **UK's** relationship with its former partners within the European Union and Britain's new role as a non-EU member will begin to take shape amidst intense negotiations over the next two years. Following the Brexit vote and the election of President Trump in the U.S. [which underscores the revival of growing nationalist sentiments globally], upcoming elections in France, Germany, and the Netherlands, point to a strong possibility of more upset victories favoring populous nationalist politicians. At the center of this revival is a quest for greater national political sovereignty, an anti-immigration bent, a shift away from liberal free-trade policies and growing resentment toward dictates issued by EU bureaucrats in Brussels. The long-term survival of the EU in its present form should not be taken for granted. The EU is again a big source of risk; France's presidential elections could lead to a fracturing of the political union, while Greece and Italy could withdraw from the currency union. Separately, the Euro-zone economic recovery remains uneven, reflecting mostly modest domestic demand and continued uncertainty about the sustainability of the entire experiment.

Meanwhile, global investors seem to have begun a gradual unwind of some of their emerging market assets in exchange for safer U.S. assets which have become more appealing since the U.S. presidential election. Investors moved an estimated $3.4 billion out of emerging markets in December alone. The current rally in the U.S. dollar, which hovers near 14-year highs, could in the short-term trigger further stress in emerging markets. A stronger U.S. dollar makes it more expensive for foreign companies and governments to repay their dollar-denominated debt. In addition, some countries are spending their foreign-exchange reserves to stem their currencies' decline against the dollar, eroding those key rainy-day resources. On the positive side crude oil prices increased by 45% in 2016 and OPEC and other major producers agreed to cut output to reduce a global supply overhang that has depressed prices for two years. This should provide a bit of renewed confidence for oil exporting economies as we enter 2017.

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China

China's currency lost 7% of its value against the U.S. dollar during 2016, twice the rate at which it fell during the previous year. Without the Chinese central bank spending $300 billion of its reserves intervening in currency markets to prevent a larger depreciation during 2016, the yuan (aka RNB) would have experienced a greater fall. Despite the 7% currency depreciation there has been no let up of pressure on the Chinese financial system during December.

Unlike other emerging markets which have mostly free-floating currencies (e.g. Russia, Brazil, Mexico) China's currency hasn't found its bottom. As a result, Chinese investors are expecting more currency depreciation ahead and continue sending money overseas. Those outflows continue to hurt future confidence in the economy. China has long relied on capital inflows to boost its money supply. When capital flows reverse, as they have over the past few years, the domestic banking system feels the strain. One sign of that is that banks are increasingly reliant on short-term funding in interbank markets, rather than more stable deposits. Keeping those short-term markets flush is a tricky task. When China's central bank intervenes in the currency markets, it sucks liquidity out of the financial system. It tries to replace that cash by lending money cheaply to banks. But it also leaves the system generally more vulnerable when pressure mounts, as seen by the dislocation in China's bond market during the dollar's surge in December.

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While Beijing will continue to fight to prevent the yuan from falling further, the wild card will be geopolitics, namely how much of a confrontation will ensue between the incoming Trump Administration and China over charges of currency manipulation and dumping of cheap steel into the American market. An escalation of tensions with the U.S. would likely add pressure to China's already slowing economy. The consensus forecast is for China's economic growth to slow even further to 6% in 2017 and 4.2% in 2018. This is perceived as a hard landing for the Chinese economy. This gloomy outlook reflects the view that the current reliance on credit-driven growth will prove unsustainable, and that a painful readjustment will come about sooner rather than later.

According to the IMF, credit growth in China during 2016 was a hefty 20.5% (following credit growth of 23.4% in 2015). These phenomenal growth rates have occurred even as GDP growth has slumped below 8%. If this credit was being channeled into productive investments, there would be less reason for concern. However, there is evidence that lending is instead heading to the less productive parts of the economy. Studies have consistently found that the private sector is far more productive and efficient than the state sector in China, but private-sector fixed assets investment has decelerated steadily since 2013. In 2016 it virtually stalled, expanding by just 2.1%. By contrast, over the same period investments by state-owned firms and those with state holdings increased by 21.4%. Credit released into the economy in 2016 appears to have been used to support frenzied real estate buying and to help struggling (state controlled) firms to meet debt repayments.

Slowing economic growth and rising lending are not usually comfortable indicators for banking sector stability, and there are growing signs of stress in China's financial system. Official measures of non-performing loans are misleading, as banks have wide leeway to categorize loans as sound if they believe that debt will be repaid- even when repayment terms are not met. Meanwhile, China's foreign exchange reserves remain a robust $3.01 trillion.

Mexico

Rising violent crime and widespread perceptions of institutional corruption will undermine the ruling PRI's chances in the 2018 general election, and could even make a bid for the center-right PAN an uphill struggle. Indeed, with the risk of a more difficult economic environment in the event of tough trade negotiations with the U.S., populist parties could see their chances for 2018 rise, threatening the preservation of President Pena Nieto's reform achievements.

While the government has successfully passed milestone structural reforms since 2012, relating to the banking sector, labor market, telecoms and the crucial energy sector, additional efforts to improve institutional quality and bring down corruption perceptions will prove increasingly challenging for the sitting President.

The sudden resignation of Mexico's central bank governor in December has added an additional source of uncertainty for the country's economy and policymaking, which could prolong the underperformance of the peso relative to the dollar and other emerging market currencies. This comes against the backdrop of heightened risks of deteriorating trade relations with the U.S., on which Mexico relies for 80% of its goods exports.

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While a lack of clarity on U.S. trade policy may remain over the coming months, vested U.S. interests and an anticipated shift toward pragmatism under the Trump Administration would preclude a sharp deterioration in trade with Mexico. Crucially, a sudden shift in central bank policy or a loss of credibility is not expected with the resignation of the former governor. For the time being, the sharp sell-off in the peso and its break through the psychologically important 20 peso:U.S.$1 level will deepen concerns over high inflation and the ability of the central bank to keep inflation expectations anchored. The 13.5% tumble in the peso since the U.S. election has seen inflation expectations adjust sharply higher, posing major challenges for the authorities to keep the peso supported. The outgoing central bank governor was considered one of the most credible policymakers in Latin America and across most emerging market institutions. He was widely credited with steering Mexico's economy through the 2008-09 global financial crisis as finance minister, and has achieved a strong track record as governor since January 2010.

Inflation remains on target despite the peso's drop to record-low levels. This comes in addition to accumulating record-high foreign reserves, which remain at a historically high $171.9 billion, despite being drawn down in 2016 on account of sharply lower oil prices and a 21% drop in the spot value of the peso against the dollar. With the economy widely expected to decelerate in 2017 (slowing from 2.1% in 2016 to 1.9% in 2017), a more dovish central bank may be able to generate more positive sentiment toward the peso, especially as the real interest rate differential with the U.S. would remain attractive to investors.

Some are expecting upside surprises in Mexico's trade negotiations with the U.S. and believe these talks could end up being more constructive than markets expect. Such optimism is left to be played out, but in the meantime keeping a close eye on Mexican companies and their ability to keep servicing their dollar debt with a weakened peso remain a key concern.

Among key themes for Latin America in 2017, we see a continuation of structural reforms, as cash strapped governments seek to attract the private sector into much-needed infrastructure development. Combined with recovering commodity prices, this will help bolster external accounts, improve public finances and support a recovery in regional growth.

Ecuador

Ecuador's current account deficit is set to narrow in 2017 and will likely flip into modest surplus in 2018 as oil exports rebound. As imports contracted due to weak demand in 2016 (anticipated at 20% reduction) they slightly outpaced the decline in exports driven by weakness in the oil sector. While a rebound in imports is forecast in 2017, the current account deficit will continue to narrow as a recovery in oil prices drives export growth.

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Weak economic activity, growing unemployment and a strong U.S. dollar have stymied import demand considerably. Additionally, the government introduced a series of duties ranging from 5% to 45% on 2,800 different products, which have caused the total value of imports to fall 38.3% between March 2015 and September 2016. Imports will begin to pick up in 2017, driven by the lifting of many import restrictions and short term tariffs which the government put in place to protect the economy's official dollarization. A quota which limited total auto imports to $280 million will be lifted in 2017.

Oil exports will return to growth in 2017 after two years of double digit declines. The consensus is that higher average global oil prices and rising production levels will bolster Ecuador's oil exports. Indeed one forecast expects increases in output of mature oil fields as new expertise and investment capital is brought into the country from two foreign oil field service majors. The effect will be to improve export levels by 15.7% in 2017 and 10.4% in 2018.

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After an earthquake in April 2016, Ecuador secured a $2.0 billion credit line from China and $364 million from the IMF in order to provide for public spending on relief and reconstruction efforts. While these funds will help stabilize Ecuador's external accounts, its weak growth and fiscal outlook will pose risks to its sovereign credit rating. Last August Fitch revised the country's credit outlook to negative, suggesting downside risk at the time.

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FCIA's Deals Of the Month

Non-Cancelable Limits Policy: $8,000,000 limit of liability covering the sale of Industrial Equipment to buyers in Europe and the Middle East for financing purposes

Key Account Non-Cancelable Limits Policy: supporting mid eight figure sales of construction equipment going to ANZ Region and the US

What is Trade Credit Insurance?

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