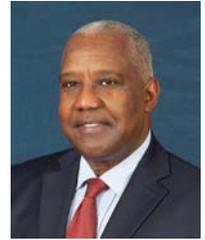


Major Country Developments October 2016



By Byron Shoulton

Overview

The IMF has warned that sluggish global economic growth could bolster an anti-trade backlash that has become a feature of political campaigns both in the United States and Europe. The Fund forecast global growth of 3.1% this year, rising to 3.4% in 2017. However it noted concern that the rise of anti-trade and anti-globalization rhetoric that has become popular in political campaigns in both the U.S. and Europe could have the effect of turning back the clock on trade. Crucially, while trade flows advanced at twice the speed of global growth prior to the great recession, the forecast now is for trade to grow at half the rate of global expansion over several years.

The Fund's outlook for growth in developed economies is particularly gloomy; with a 1.6% expansion expected this year, compared with 2.1% last year. Emerging economies by contrast, are expected to grow at a 4.1% clip, largely driving global growth over the next year. Highlighting concerns that many have about the U.S. economy's ability to attain a robust level of growth; the IMF slashed its forecast for the U.S. to 1.6% from 2.2% forecast previously. Coming eight years after the financial crisis and after a wave of aggressive policies by central banks around the world, these growth figures are disappointing and are indicative of the inability of global policymakers to address underlying fundamental economic weakness.

Central banks in advanced economies have been doing their best to pep up demand over several years. Now they need help as their signature policy, of keeping interest rates low or even negative, is not achieving the desired effects of spurring sufficient growth. The central bankers say that ultra-loose monetary policy remains essential to prop up still-weak economies and hit their inflation targets. The Bank of Japan,

for example, promised in September to keep ten-year government bond yields at around zero. The U.S. Federal Reserve in September put off a rate increase until a later date. In the wake of the Brexit vote, the Bank of England has cut its main policy rate to 0.25% the lowest in its 300-year history. A growing chorus of critics frets about the effects of this low-rate environment in advanced economies, where savers are charged a fee and where the yields on a large fraction of rich-world government debt come with a minus sign. There are complaints that central banks matter more than markets in deciding how capital is allocated. No surprise therefore, that politicians have waded in on the debate. In the U.S. the Chair of the Federal Reserve has been accused of keeping interest rates low for political reasons. In Germany the European Central Bank has been blamed for the rise of the right-wing party.

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Separately, there are signs pointing to more global instability. In the developed world beginning with the UK's vote to exit the European Union, which is still unfolding, to uncertainty surrounding the outcome of the November U.S. presidential election, these represent only the beginning. In France, where Marine Le Pen, leader of the National Front boasts that she wants to add "Frexit" to Brexit. Ms. Le Pen is almost certain to be one of the final two candidates for the French presidency in 2017. Meanwhile, misgivings about future free trade agreements appear to be increasing and mistrust among nations (even those which remain in the EU) have grown. Globalization seems to have

reached a plateau and in some areas, is in reverse. Some firms are already wary of long-term investments given slow global growth. Rising political risks could reinforce such hesitancy. For the time being some companies may prefer shorter-term bets. There is growing evidence that companies are stashing cash in safe securities as they wait to see what “Brexit” will actually mean for trade, access and financial flows within the wider European market. Equally, there are uncertainties over what policies will be pursued in the U.S. after the presidential election and if they will lead to sustainable growth and support more global trade. Yet if businesses pull back on long-term investments, that may only encourage more instability. A vicious cycle, of low corporate spending that encourages stagnation that in turn produces popular discontent and more political turmoil, could begin to spin faster.

Troubles surfaced anew in **European** banking as Deutsche Bank, Germany’s largest bank saw its shares sink by more than 50% this year to its lowest level since 1992. The sell-off spread to other European banks, with all lenders on the Euro Stoxx bank index in the red at one point in September. Speculation over whether the German government would provide state aid to Deutsche Bank ahead of elections in Germany next year was rejected by the German Chancellor, thus contributing to uncertainty regarding the bank’s fate. The German government has reportedly also ruled out intervening on the bank’s behalf in the U.S., where the Department of Justice has asked Deutsche to settle a record \$14 billion fine against allegations of misselling mortgaged backed securities. Deutsche has said it will not pay anywhere near the threatened fine, which is close to its current total market capitalization of \$18 billion.

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The bank’s leadership insists that it will not seek a government bailout. Deutsche is reportedly under intense pressure from investors. A number of hedge funds have built up bets that the bank will fail. On a market cap basis, Deutsche now ranks 78th among global banks, just below Malaysia’s Public Bank and Brazil’s Itaúsa Investimentos Itaú. Many investors do not believe that a restructuring plan, unveiled a year ago, will be enough to alter the bank’s fortunes. Some are pushing for a sale of the bank’s asset management division, while others want to see deeper cost cutting.

Still, the market sentiment is that the German government will stand firmly behind Deutsche Bank if needed. For nationalistic and reputational reasons, the German government would not allow a massive dislocation of the financial system if it became clear that Deutsche Bank faced serious problems. More broadly, institutions like the IMF point to Deutsche as the world’s riskiest globally significant lender. Others note the key challenges for the German banking sector remain ultra low interest rates weighing on profitability, regulatory pressures, and intense competition and, in the case of Deutsche Bank, misconduct and litigation charges.

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Brazil

The economy will contract by -3.3% in 2016, following a -4% decline in 2015. A slow turnaround is forecast over 2017 and 2018. Brazil’s deep recession has many roots. Policymaking in recent years has failed to tackle long-standing structural problems, contributing to the erosion of confidence and a large contraction of output over two years. The recession was made worse by other factors including a slowdown in demand for raw materials in China [which became Brazil’s major trading partner in the last decade], tight financing conditions, necessary but steep increases in

electricity tariffs, a corruption scandal, and a political crisis which has underpinned heightened uncertainty. The recession has taken a massive toll on employment and progress in reducing social inequities has slowed. Despite a large output gap, inflation has exceeded the official target since 2015. Furthermore, the end of an era of above-average growth, based on a consumption boom and high commodity prices, has exposed structural fiscal fault lines. The decline in potential growth and persistently high real interest rates have contributed to a significant worsening of the country's debt dynamics.

The government has committed to an agenda of fiscal and structural reforms for 2017 and beyond. It has proposed a cap on growth in federal spending at the rate of consumer-price inflation in the previous year and announced plans for social security reform. The government has also initiated regulatory reforms in support of the concessions and privatization program, strengthened the governance framework for state owned enterprises, and hinted at further structural reforms to come. Major public enterprises and banks, notably Petrobras and BNDES, have been placed under new management. Markets are responding positively of late to decreasingly uncertainty, further boosted by improving sentiment toward emerging economies.

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The outlook is for growth to resume gradually in 2017, as there are tentative signs that the recession is nearing its end. After a projected contraction of -3.3% in 2016 output is expected to pick up by 0.5% in 2017. This projection is based on the assumption that the proposed fiscal spending caps and social security reforms are approved in a reasonable timeframe, and

that the government will meet the proposed fiscal targets for 2016 and 2017. With these improvements on the fiscal front, and assuming uncertainty continues to decline, investment is expected to begin to recover, supporting a gradual return to sequential growth beginning in late 2016. A more rapid recovery in economic activity is hampered by excess corporate leverage, high unemployment, and weak balance sheets of households. Inflation is gradually expected to converge toward 5.5%, the midpoint of the target range.

Still, downside risks continue to dominate Brazil's short-term outlook even while some upside opportunities are emerging. The government could be slowed in rolling out its fiscal consolidation strategy. Policy implementation challenges include navigating reforms through congress in a tight timeframe that may surface. If key reforms are watered down or get stalled in congress, the boost to confidence will be short lived, and the recession could continue, putting further stress on income and balance sheets throughout the economy. Also, any re-intensification of political uncertainties will be a drag on growth.

External risks such as a more protracted period of slow growth in advanced and emerging economies, especially China, further declines in commodity prices, and tighter external financial conditions cannot be ignored. Some upside opportunities have emerged including recent policy pronouncements which have boosted confidence and asset prices. If this gathers further momentum it could facilitate a reduction in Brazil's risk premium, triggering a more vigorous turnaround in investment (including mergers and acquisition activity) and growth.

Given the perception of systemic corruption, the government's commitment to make data on public procurement open, to implement legislation on conflict of interest, and to strengthen whistle blowing mechanisms will go a long way toward increasing transparency. The effective implementation of transparency, anti-corruption and anti-money laundering

measures would contribute to enhancing predictability for businesses and ensuring a greater perception of fairness in the system going forward.

Meanwhile, since the beginning of impeachment proceedings against former President Rousseff, shares of State-controlled oil giant Petrobras have bounced back [up 70% since December 2015]. Under new leadership Petrobras has begun to lighten its debt load. With gross borrowings of \$124 billion Petrobras ranks as the world's most heavily indebted listed energy company. Now the goal is to reduce Petrobras' net debt from a hefty 5.3 times earnings last year to 2.5 times by 2018. Part of the new debt reduction strategy involves cutting Petrobras' investments between 2017 and 2021 to \$74.1 billion, a fall of 25% compared to the company's previous forecast. The new leadership at Petrobras is seeking to introduce transparent pricing rules, ending one of the most contentious and damaging practices while the Worker's Party was in power.

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The company had been forced to subsidize domestic fuel prices as part of the government's efforts to control inflation. From 2011 to 2014, the government which directly and indirectly controls 61% of Petrobras' voting shares, required the company to import gas and diesel and sell it at a loss in the domestic market. With a new business-oriented policy for fuel prices now in place, prices will be adjusted regularly, based on the value of international oil and currency movements. Less state interference going forward will also allow Petrobras to downsize, creating opportunities for overseas companies to acquire assets focused on ethanol, fertilizer and petrochemicals which the oil producer intends to sell.

Already disposing of \$15.1 billion of assets in 2015 and 2016, including one of the largest offshore oil licenses to Norway's Statoil for \$2.5 billion, Petrobras proposes to make divestments worth \$19.5 billion during 2017 and 2018. Its gas station chain BR Distribuidora is one of the most coveted assets up for sale. As Petrobras is pushed into rebalancing its priorities this will likely create more opportunities for international oil companies and other investors in Brazil's energy sector. Petrobras will benefit from other legislative changes under interim president Michel Temer's more business friendly government.

The lower house is forecast to approve legislation that would relieve Petrobras of its obligation to be the lead operator in Brazil's deepwater 'pre-salt' oil and gas fields. The move would allow the company to further reduce its investments.

Mexico

The forecast for economic growth have been lowered for 2016 and 2017 to 2.2% and 2.6%, respectively in light of ongoing weakness in the U.S. manufacturing sector. The economy should continue to grow modestly before expanding by a more robust 2.8% in 2018-2020 as investment recovers and the benefits of structural reforms gradually materialize. Having successfully passed key reforms during the first half of his six-year term, Mexican President Pena Nieto will have a significantly more challenging policy environment over the remainder of his time in office. The next two years are likely to be characterized by more intense opposition to government-sponsored bills, while greater emphasis will be placed on the government's poor track record in tackling crime and corruption. The president's approval rating has hit record lows. As a result his party (the ruling PRI) faces an uphill struggle ahead of the 2018 presidential election.

With continued near term uncertainty, the central bank has taken aggressive action to limit recent

volatility for the peso. With the outcome of the U.S. presidential election still too close to call, exchange rate volatility will likely persist. Given the implications of a potential victory for Republican Donald Trump, domestic bond and money markets are increasingly pricing in an interest rate hike by Mexico's central bank by year-end 2016. The central bank has

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previously shown its resolve to prevent sharp capital outflows and support the exchange rate, hiking the target rate twice by 50 basis points earlier in 2016. Mexico's deep local currency bond and money markets, and its large international portfolio liabilities leave the peso vulnerable to shifts in investor sentiment. Concerns about the implications of a Trump victory weigh on the currency because of Mr. Trump's high priority policy platforms on trade and immigration. This has been the primary driver of the peso's recent decline. Mr. Trump has suggested that the U.S. participation in the North American Free Trade Agreement (NAFTA) would be reassessed if he became president. While the probability of the U.S. pulling out of NAFTA even under a Trump presidency is small, the U.S. could increase pressure on Mexico to accept less favorable trade terms, with only a limited risk of facing significant repercussions from international arbitration courts.

Indications are that a Clinton victory could trigger a rally in the peso. Recovering oil prices and an improvement in Mexico's public finances will support additional currency appreciation beyond 2016. However, room for a sharper appreciation is limited by weak U.S. demand for Mexican vehicles, machinery and electrical equipment and mechanical appliances exports. In addition to low energy prices, the decline

in Mexican goods exports has been gaining pace recently, with exports declining for the 12th consecutive month in July. Indeed, the contraction in goods exports deepened to a six-year high of 6%.

Mexico and Central America have by far the highest exposure to the U.S. economy for their exports. Mexico in particular, is in a league of its own when it comes to the share of goods exported to the U.S., which accounts for over 81% of total goods exported last year. With exports accounting for a large share of GDP in Mexico (35%), declining trade volumes could send shockwaves across the country's manufacturing sector, leading to a drop in business investment, potential job losses, and a decline in overall economic output. Indeed, disappointing durable goods orders in the U.S. and a recent downward revision of the U.S. GDP growth forecast have prompted revision of Mexico's growth forecasts for both 2016 and 2017 to 2.2% and 2.6%, respectively.

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Mexico's latest budget plan outlined by its new Finance Minister highlights the government's unwavering commitment to conservative fiscal policies – even as the Mexican president's approval ratings are at record lows and the economy struggles to gain traction. The budget deficit is forecast at 3.1% of GDP in 2016 and 2.8% in 2017. However, the public debt is expected to rise slightly to 46% of GDP in 2017 from 45.8% in 2016. Only gradual improvements are expected beyond; to 43% of GDP in 2018 and 42.3% in 2019. The proposed spending cuts will temper Mexico's debt levels over the next few years. Rating agencies S&P and Moody's lowered their sovereign outlooks for Mexico in 2016, citing the risk of a rating downgrade rising over the coming years. The recently proposed budget, if passed by the congress, will step up financial consolidation efforts with higher spending cuts (equivalent to 1.2% of GDP in 2017). This

will narrow the budget deficit, reduce capital outflows and help prevent a ratings downgrade. Notwithstanding Mexico's continued commitment to prudent fiscal policies, the recent rise in foreign denominated currency public debt leaves the country's sovereign credentials increasingly exposed to heightened exchange rate volatility.

The unemployment rate reached 3.9% in the second quarter of 2016. This is the first time since the 2008-09 global crisis that unemployment has fallen below 4%. Limitations of fiscal reform and the sharp drop in oil revenues will compel the federal government to consider further tax measures, even though a pledge to the business community not to raise new taxes until 2016 is respected.

Turkey

Turkey's 2016 GDP growth slowed to 3.2%, its current account deficit rose above 4% of GDP, tourist arrivals fell by a third and the country's external liabilities topped \$155 billion – about 26% of GDP. Both Moody's and S&P have downgraded Turkey's debt rating to junk status, following the failed coup attempt in July. Citing Turkey's exposure to foreign capital outflows, falling foreign exchange reserves and muted growth prospects, Moody's opined that the likelihood of a balance of payments crisis has increased. While keeping the country outlook at "stable", Moody's cited the erosion of Turkey's institutional strength, referring to the sustained attacks by President Erdogan on the independence of the central bank, which under a new governor has delivered consistent rate cuts despite failing to meet its inflation targets.

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While Turkey has consistently been able to roll over its debts, the downgrade will likely inflate financing costs [by as much as 50% according to some estimates] over the next year. The government has failed to deliver on economic reforms over the past year and is now focused on dealing with perceived threats to its survival following the attempted coup. Economics has been reduced to simple populist measures aimed at sustaining short-term growth. Instead of proposing a new structural reform package, the government appears more prepared to pursue an ad hoc strategy that is unlikely to address long-term challenges facing the country.

While it is likely that Turkey's turn inwards in the wake of the coup attempt will not seriously affect its trade with the EU in the short to medium term, Turkey's further integration in this body is becoming increasingly unlikely.

Turkey's economy is quite dependent on foreign trade, and its trade in goods is particularly sensitive to movements in foreign exchange rates. Its imports are largely denominated in U.S. dollars due to imports of fuels and energy products, and trade with Asia. About half of Turkey's exports are settled in euros, as the EU is its main trading partner. According to the WTO most of Turkey's exports are manufactured goods, in particular textiles and clothing (18.5%), automotive products (11.1%), chemicals (5.8%) and iron and steel (6.8%). Exports of agricultural products account for 11.7% of total exports. Turkey's imports are mostly raw materials such as fuel and intermediate goods, which are used as inputs to produce higher value-added finished goods for export; the principal items relate to machinery and equipment (27%), mining (15%), chemicals (13.5%) and a variety of consumer goods.

Tourism is also important to the economy, both for



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foreign exchange earnings and for providing employment in the formal and informal sectors. Whether or not visitors will again resume travelling to the country as they did before the attempted coup, is left to be seen.

Turkey faces a dilemma in structuring its trade policy going forward. It has benefited greatly from its Customs Union with the EU, introduced in 1996, which has reinforced the EU's role as Turkey's largest trading partner. A major benefit has been the harmonization of Turkey's technical trade legislation and regulatory standards with those of the EU. However, the EU is suffering from a protracted economic slow-down. Furthermore, the aborted coup in July 2016, the declaration of emergency, mass arrests of public officials and the possible reinstatement of the death penalty – serve to further estrange the country from the European public and increasingly, from the EU leadership as well. While it is likely that Turkey's turn inwards in the wake of the coup attempt will not seriously affect its trade with the EU in the short to medium term, Turkey's further integration in this body is becoming increasingly unlikely. The signs are that under President Erdogan the country will pivot gradually away from Europe and towards Russia, Central Asia and China.

While President Erdogan recently extended the state of emergency [which was introduced after the failed coup attempt] for another three months, he asserted that even if the state of emergency remained in place another year, Turkish citizens would be content with it.

Meanwhile, Moody's recently downgraded the long-term debt and deposit ratings of ten Turkish banks due to a combination of reasons including the weakened operating environment, which the rating agency expects will gradually exert negative pressure on the individual banks' asset quality, earnings and capital. The rating agency cited increased downside risks to funding and liquidity as the banks need to

refinance large amounts of maturing debt in a difficult domestic and global environment. Finally, it noted the reduced capacity of the government to provide support to the financial sector if needed, as implied by the downgrade of the country's sovereign rating.

*By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at
bshoulton@fcia.com*

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