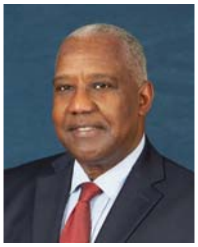
Major Country Developments
August 2018



By Byron Shoulton

Overview

According to the OECD, global inflation hit its highest level in four years led by a surge in energy prices. Consumer prices in the Group of 20 largest economies - which account for 80% of global economic output- were 3.1% higher than a year ago. This puts global inflation at its highest level since June 2014. Much of the recent uptick in prices resulted from a jump in energy prices, which were up 10.4% over June 2017 levels, the fastest annual increase since November 2011. The pick-up in inflation comes after a number of years during which inflation remained low, even during steady rates of economic expansion and falling unemployment. A growing number of the world's central banks are now joining the U.S. Federal Reserve in lifting interest rates over the coming months, as inflation finally responds to a period of solid global growth, although those plans could be scrambled by rising trade tensions between the major economies.

The **U.S.** continues its pursuit of a protectionist agenda with threats of additional tariffs on goods from the **EU, China** and elsewhere. The U.S. further ramped up its threats against Chinese imports, by raising the initial proposed tariffs on an additional $200 billion of Chinese goods from 10% to 25%. A final decision on the rate isn't expected until September at the earliest. U.S. officials are confident that they have the upper hand in the trade fight with China because the U.S. economy appears to be gathering strength while the Chinese economy show signs of weakening and is more dependent on trade than the U.S. Economic growth in the U.S. was strong despite trade tensions, with second quarter GDP growth at 4.1%, up from 2.2% during the first quarter, while unemployment fell to 3.9%.

President Trump has indicated that, if necessary, he is prepared to impose high tariffs on all Chinese exports to the U.S. [$505 billion in 2017], to force a change in Chinese policies. The Chinese government has pledged to retaliate against U.S. tariffs "in equal scale and equal strength", including the possibility of imposing new tariffs on U.S. liquefied natural gas, chemicals and machinery, among others. The escalating tensions between the world's two largest economies carry substantial risks for China and for the global economy.

The growing list of imports that will be subject to U.S. tariffs may be counter- productive as several U.S. trading partners have responded with their own tariffs on U.S. exports, resulting in a fall in demand for certain U.S. goods. These include a range of agricultural products. With the erosion of foreign demand caused by the tariffs, warehouses across the U.S. are reportedly overstocked with agricultural products meant for export. The Administration announced a $12.5 billion support program for the farming sector, a recognition that counter tariffs imposed by trading partners are starting to hurt certain U.S. exports. Tariffs are starting to sting U.S. consumers as well. Higher prices went into effect for recreational vehicles, beer, soda, and other goods that now cost more to make as a result of recent U.S. tariffs on imports of metals and parts. The boost in the cost of a range of goods comes at a time when inflation is picking-up. This will become another factor for the Federal Reserve to consider as it decides how quickly to raise interest rates.

China's exports declined by 0.4% in July and its Business Activity Index fell 3.1 points below the 50.6 reading of the previous 12 months. Slowing domestic activity reflects tightening credit conditions as the Chinese leadership attempted to rein in financial excesses and to control risks. While GDP growth is close to the 6.5% target set for 2018, the government appears worried that global tension risks leaving the economy vulnerable to a steeper downturn. The government appears to be now tweaking its policies and fine tuning its language to increase the flow of loans to businesses while spiking fiscal spending. While 2018 is shaping up to be a record year for defaults, recent measures to increase the flow of credit to the corporate sector show heightened concern about the collateral damage caused by the earlier deleveraging campaign. However, the IMF warned in late July that a return to credit-fueled investment would be a mistake, and urged Beijing to hold the line. China is also taking steps to prevent its currency [which has weakened recently] from falling further. Failure to shore up the RMB creates risks of China being labeled a currency manipulator by the U.S., adding fuel to an already tense relationship.

The **UK** is in the midst of deciding how much to isolate itself from the European economy post-Brexit. Negotiations between both sides are not going well. Meanwhile, other leading trading nations are choosing to embrace economic globalization. The **European Union** and **Japan** reached a free trade agreement in July, eliminating tariff barriers and reducing non-tariff obstacles to trade. That move amounts to the removal of tariffs on trade for one-third of the global economy. Furthermore, the EU has reached out to China seeking collaboration on overhauling the World Trade Organization (WTO), with the aim of strengthening that body's ability to monitor and protect the global trading system. China has endorsed the EU-Japan agreement, noting that free trade remains attractive as more trading blocs are being formed around the world. This includes the 11-nation Trans Pacific Partnership, that was originally meant to counter China's emerging dominance and from which the U.S. withdrew in early 2017.

While the U.S. Administration appears suspicious of the WTO's effectiveness in combating unfair trade practices, countries including Japan, the EU, **Canada, Mexico**, among others, seem bent on maintaining the postwar free trade system and insist they are prepared to defend the existing rules-based world order established over the past 70 years [in which the U.S. played a leading role]. The U.S. is focused on using bilateral trade agreements as an alternative to the multilateral approach that gained currency over several decades.

Europe

Economic growth in the Eurozone slowed in the three months through June, as exports weakened and business confidence fell on worries over future relations with the bloc's largest trading partners. According to the EU's statistic agency, the combined GDP of the 19 countries using the euro increased at an annualized rate of 1.4% in the second quarter, down from 1.5% in the first. That was the slowest expansion in three years.

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The **Eurozone** economy began 2018 on a high note, having racked up its most rapid expansion in a decade during 2017. However, growth slowed sharply in the first three months of this year, a setback which was attributed to unusually cold weather and a series of labor strikes in **Germany** and **France**. The failure of the economy to rebound in the second quarter indicates that other forces are at work. Business surveys point to a fall-off in export growth and a waning of business optimism that appears to be linked to growing trade tensions between the U.S. and the EU and uncertainties about access to U.K.

markets after Britain leaves the trading block next year. Higher oil prices are another contributor to slower EU growth, as they eat into households' spending power.

The head of the European Commission met with President Trump in July in an effort to head-off the imposition of additional U.S. tariffs threatened on European cars. The two leaders appear to have agreed to work toward removing all tariffs and non-tariff barriers by each side over time. During this period when negotiations will be ongoing, it appears the U.S. will consider holding off on imposing additional tariffs on European cars and other goods. The EU apparently is also willing to withhold imposing additional tariffs on U.S. exports while negotiations continue. Confidence could rebound if progress is made in talks to resolve trans-Atlantic trade tensions announced by President Trump and the EC President.

Nicaragua

The political situation in Nicaragua took a turn for the worse when anti-government protests resulted in 448 deaths at the hands of paramilitary forces loyal to President Daniel Ortega. Demands for the removal of Ortega and his government have grown louder and his government has lost the support of the vital private sector.

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Regional governments and the U.S. have also called on Ortega to step aside. Capital flight will intensify and access to foreign lending will be hard to come by in the current environment. Confidence has fallen to its lowest level in more than a decade. Concerns over who or what will replace the regime (should Ortega decide to resign) is a major issue, as there is no one leader who is seen as an alternative to Ortega. The impasse could drag on over several months.

Argentina

Argentina was hit hard by a sell-off of emerging market assets during April-June, but this subsided in July. Turbulence in the foreign-exchange market was calmed by the announcement of a three-year $50 billion IMF standby lending agreement with Argentina. The country drew down $20 billion of this facility and will keep the remainder as an emergency backstop in case of a future currency crisis or a run on the country's banks, due to loss of confidence. Economic growth has been weak due to low investment and very high inflation.

A spike in inflation in June reflected the impact of the sharp depreciation of the peso in the previous month, which led to a dramatic increase in producer prices. With confidence in monetary policymaking and the inflation target currently extremely weak, pass-through to consumer prices has been substantial and is likely to remain so in coming months. Inflation expectations have risen persistently since late 2017 and according to the latest market survey by the central bank, expectations for end-2018 inflation rose to 30% (up from 27.1% in June). Inflation expectations for 2019 are at least more stable, at around 20%. The biggest driver in inflation continues to be utility price adjustments being undertaken to reduce the fiscal burden of subsidies. There are also price pressures being felt in healthcare, education and communications.

The expressed support for the policies of the sitting government by the IMF, signals continuity in ongoing reform efforts to restore stability and promote more solid and stable economic growth. The sitting government of President Mauricio Macri will have to reckon with the long-held unpopularity of the IMF among the Argentine populace, which could weigh on his popularity ahead of the next presidential election due in October 2019. Nonetheless, the consensus is that Macri could win a second term based on the assumption that some recovery in GDP

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growth and a reduction in inflation would have occurred by the time the elections are held. The government is pursuing an agenda centered on job creation, infrastructure and food security. It has made progress since coming to office at the end of 2015 and began grappling with restoring macroeconomic stability while improving conditions for businesses. The only major change foreseen in economic policy-making going forward, is a more rapid tightening of fiscal policy.

Argentina's relations with key international partners are expected to continue to improve under the Macri Administration, which took over the rotating presidency of the G20 group of countries in December 2017. This is considered a milestone in restoring Argentina's international image. The government is keen to secure deals under the auspices of Mercosur (the Southern Cone customs union). The problem for Argentina and its Mercosur partners is that, just as the grouping has started to reverse its own protectionist tendencies, anti-globalization sentiment has grown in the OECD. However, Mr. Macri is continuing to seek support for an EU-Mercosur trade deal from his counterparts in Europe, and negotiations are continuing, although they are moving slowly. Meanwhile, Mercosur members including Argentina have pushed for free-trade negotiations elsewhere, including with Canada and China, and for closer relations with the Pacific Alliance free-trade area.

The reduction of inflation will continue to be complicated in the short term by gradual increases in utilities prices as these are brought closer in line with market prices. Recent rapid peso depreciation is likely to produce substantial pass-through effects, and keep inflation higher than desired. However, the recent tightening of macroeconomic policy should have a beneficial impact on inflation over time. With policy interest rates at 40% for over two months, growth in the money supply has fallen from over 35% early in 2018 to under 25% in mid-July. Combined with public spending cuts, this suggests that monthly inflation should in coming months fall below 1.5% on a sustainable basis, barring fresh shocks. Still, the pace of disinflation will undoubtedly be slow, given that the government remains committed under the IMF lending deal, to cutting the fiscal deficit (to 1.9% of GDP in 2019 from 2.7% this year) by further reducing the burden of energy subsidies.

Markets will watch closely as the October 2019 election approaches. Business leaders and big farming enterprises hope Macri will win a second term and continue his free market reforms. He came to office after a decade of heavy state intervention in the economy under presidents from the opposition Peronist party.

While the recent drought in Argentina hit the soy crop hard, a record wheat harvest this year could arrive just in time to jumpstart the ailing economy in the fourth-quarter. Farmers are rushing to plant more wheat in the moist conditions left by rainstorms that helped damage the recently harvested soybean crop. Months of dry weather gave way in April to three weeks of storms that helped cut the soy crop to 35 metric tons from original estimates of 55 million metric tons. The humidity left behind set the stage for an increase in the 2018/19 wheat planting. The forecast is for a record 20 million metric tons of wheat, topping the current record of 18.2 metric tons collected in 2016/17. This should fetch $3 billion in export revenue, helping Argentine farmers to expand sowing of the two main cash crops of soy and corn in October. The crop forecast could go higher if the weather remains good. The bumper wheat crop comes as several suppliers around the world – including

Germany, France and Russia – have seen their harvests cut by bad weather.

Turkey

Many Turkish entities have been able to survive years of turbulent politics and economic turmoil, but the slide of the lira have caused fresh headaches for manufacturers and other businesses that rely on imported materials. Together with already soaring inflation, the lira's recent plunge deepened – after the central bank kept interest rates unchanged in late July. At the first monetary policy meeting presided over by President Erdogan's new economic chief (who happens to be also his son-in law), the central bank's decision to not raise rates, dashed hopes for a turn to more orthodox monetary policies.

Following Mr. Erdogan's re-election victory in June, the weakening lira is setting off alarm bells, with warnings that this will likely spark higher inflation, putting more pressure on an indebted corporate sector and likely deter vital inflows of foreign capital. Foreign creditors' concerns about the balance sheet health of Turkey's private sector, will likely lead to a contraction in capital inflows. That would put further pressure on the currency and risks placing Turkey in a downward cycle.

The lira has been declining against the dollar since the end of the global financial crisis, but its descent has accelerated in recent months. The currency lost 25% of its value so far this year, as foreign investors have grown wary about the country's economic management. The economy grew by 7.4% in 2017, but the nature of that growth, which was driven by consumption and a government stimulus, has caused overheating and imbalances. Annual inflation is now over 15%. The current account deficit has widened to more than 6% of GDP.

The weak currency is having a negative impact on prices across the economy: bread prices increased by 15% in July. Prices on electronic goods (e.g. I Phones) jumped by 25%, and that for imported raw materials have doubled in lira terms, as global price increases were exacerbated because of the weakened lira. Car manufacturers are feeling the pressure, as are other industries which rely on imported inputs. Many other companies are feeling pressured (or soon will be) - especially those with high foreign currency debt but who do not export. This is one of the biggest concerns, as the falling lira is putting excessive pressure on Turkish based companies saddled with approximately $300 billion in foreign denominated debt. Several have acknowledged losses in the billions of liras and a number of high profile conglomerates have reportedly asked banks to restructure their loans.

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The fear is that increasing corporate bad debts will put pressure on the Turkish banking sector, although the average level of non-performing loans (NPL's) in the sector currently stands at 3%. That figure will almost certainly grow in the months ahead. There is some division over the gravity of the threat facing the financial sector, because Turkish banks were overhauled after a financial crisis in 2000, and had their capital adequacy ratios raised. The consensus is that the banks are mostly in a good position to absorb temporary shocks. However, if the pressure intensifies, bank profits will begin to take a hit. It is true that high inflation is not a recent occurrence and Turkey's economy has defied warnings of doom in the past. Some Turkish business leaders argue there is too much pessimism over President Erdogan's stewardship of the economy. However, foreign creditors and financial institutions with large foreign currency exposures to Turkish entities are not as sanguine.

Furthermore, tensions between Turkey and the U.S. took a turn for the worse after the U.S. imposed sanctions on two Turkish government ministers, over the detention in Turkey of a U.S. pastor. It is left to be seen how the Turkish authorities will respond to this latest dust up. In the meanwhile, creditors have grown nervous and are seeking to reduce exposures to this market where possible. However, Turkey needs about $200 billion each year in foreign financing – which it obtains chiefly in the form of short-term "hot money" flows- to fund its current account deficit as well as maturing debt.

India

In July India's central bank raised interest rates for a second time in quick succession, noting growing inflationary pressures, following the government's recent decision to raise minimum prices for farmers. The Reserve Bank of India raised its policy rate to 6.5% at the end of July, after raising them by the same 25 basis points in June. That was the first rate increase since the Modi government came to power in 2014. Explaining its decision, the central bank cited the government's recent increase of minimum support prices guaranteed to farmers, which will have a direct impact on food inflation while driving up headline inflation. Retail inflation had already risen slightly to 5% in June and the RBI stressed its commitment to keep the figure close to the 4% target.

India is one of several large emerging markets to have raised interest rates this year, as their currencies came under pressure from the U.S. Federal Reserve's gradual tightening of monetary policy. The Indian rupee has fallen in value by 7.5% against the U.S. dollar since the start of 2018, although its value stabilized during July. Some Indian experts have argued that the rupee should be allowed to slide in order to smooth the economy's adjustment to external developments. With oil prices rising and other currencies depreciating, a rupee depreciation is viewed as part of the adjustment mechanism. The persistent outflows from India's domestic capital market is blamed on tighter liquidity in advanced economies and growing geopolitical concerns. The RBI stressed that rising trade protectionism poses a grave risk to near-term and long-term global growth prospects.

Meanwhile, Indian economic activity appeared consistently strong, with earnings among consumer goods companies reflecting buoyant rural demand. Still, some analysts argued against the recent rate increase, warning that India's economy remained fragile even with evidence of a rebound. They argue that a recent rise in inflation was a short-term phenomenon that would likely dissipate in coming months.

India's farming sector experienced sudden and sharp price fluctuations, rising production costs and low productivity. In recent months this led to mounting discontent that has boiled over into dramatic – and sometimes violent protests among farmers. As Prime Minister Modi gears up for a tough re-election battle next year, he is moving to shore up his flagging support among this large constituency. Following a series of state-level farm loan waivers, the Modi government announced in July that it would sharply increase the price it will pay for crops it purchases for the country's public food distribution program. The average increase of this so-called "minimum support price" (MSP) will amount to a 15% rise – the highest annual increase in six years.

The government says the move – expected to add $1.6 billion to the budget over last year's outlays [if the volume of crops bought remains the same], reflects its commitment to the welfare of farmers. However, there will be a high price to pay in terms of accelerated inflation and uncompetitive agricultural exports, which will further pressure the merchandise trade deficit.

India has long tried to juggle its twin [and contradictory] goals of keeping food prices cheap for the urban masses, while shoring up farmers' incomes. The government's main tools for this balancing act are export restrictions, import tariffs and its vast subsidized food program – for which it buys millions of tons of grains, oilseeds, etc., at preset prices each year. However, only about 10% of farmers can sell to the government, whose warehouses are already overflowing with surplus grains. Nevertheless the MSP has an outsized effect on the wider economy.

Until now, the Modi government has been relatively conservative in raising the MSP, which is credited with helping rein in India's once rampant inflation. Last year's increase was just 6%. But with upcoming elections, the government which has pledged to double farmers' incomes by 2022, has now yielded to political pressure for a more generous payout. This could cause inflation to begin moving upwards once again.

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Political Risk Policy: 8 year tenor, $20 million limit of liability, non-payment due to specified political risks in Mining Sector, Ecuador

Bank Policy - Purchase of Receivables Coverage: $15 million limit of liability protecting the bank against nonpayment on purchased A/R in the Commodities Sector, Western Europe

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