

Major Country Risk Developments November 2019



By Byron Shoulton

Overview

Global foreign direct investment (FDI) contracted sharply in the first half of 2019 as trade tensions between the U.S., Europe and China weighed on the global economy. The flows fell by a fifth in the first six months of 2019 compared with the second half of the previous year, to \$572 billion, according to data from the Organization of Economic Cooperation & Development (OECD). The drop was particularly concentrated in the second quarter, when flows contracted by 42%. FDI flows into the U.S. dropped by more than a quarter from the latter half of 2018 to the first half of 2019, to \$151 billion, while flows into the EU dropped by 62% to \$107 billion. By contrast, flows to China increased by 5% to \$82 billion. FDI flows from China to the U.S. peaked at \$16 billion in the second half of 2016 and have since fallen to less than \$1.2 billion as Chinese companies invest less and sell off some of their holdings, the OECD said. These developments reflect, in part, uncertainty over trade tensions and the future economic relationship between the U.S. and China.

Bilateral trade has also shrunk. Exports between the two economies contracted by 10 per cent in August compared to the same month last year. Average U.S. import tariffs on Chinese goods rose to 21 per cent in September, from 3 per cent in 2018, according to the Peterson Institute for International Economics. The two countries are reported to be close to finalizing a trade deal that could relieve the tensions. However, it remains possible that the U.S. could levy tariffs on European cars.

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Other countries were also affected by the global investment slowdown. FDI into the UK dropped from \$44 billion in the second half of 2018 to \$19 billion in the first half of 2019, after falling 33% in 2018, as investors braced for the UK's departure from the EU. The U.S.-China trade war and the weakening of global trade and investment have led some to call into question the future of globalization. The number of new investment restrictions or regulations rose by nearly 50 per cent in the five months to February compared to the previous five months, according to the latest data from the United Nations Conference on Trade and Development (Unctad). The rise pushed the share of restrictive investment policies to 34%, the highest proportion since 2003. There are rising concerns that the world would split into competing regional blocs that do not co-operate on trade or investment.

U.S. reinvested earnings turned positive in the first half of 2019, after being negative last year as companies repatriated profits following the Trump administration's 2017 tax reform. But they remained lower than the half-year levels recorded between 2013 and 2017. This could reflect a "new normal" as U.S. companies have less incentive to hold cash at their foreign affiliates as a result of the tax reform.

USA

U.S. economic growth cooled slightly in the third quarter to its slowest pace in 2019 as business investment declined. According to the Commerce Department, GDP expanded at an annualized 1.9% rate during the quarter ended September 30, compared with 2% growth in the second quarter. However, the overall pace exceeded expectations for growth of

1.6%. Final sales to domestic purchasers, which groups personal consumption, imports and business investment, grew at a rate of 3.4%, down from 5.8% in the previous quarter. The data shows that U.S. consumers have become slightly more cautious. Personal consumption expenditures, a measure of what households buy, cooled to 2.9%. That is down from 4.6% in the second quarter, but still ahead of expectations.

Consumers held off on buying more expensive items, such as cars and furniture — both categories registered declines. They also backed off on lower-cost goods, like shoes and clothing, and spent less on recreation and dining out. Personal consumption is the last category to feel the effects of a slowdown, but also one watched closely by analysts and the Federal Reserve. In the U.S.'s consumer-driven economy, household spending makes up more than two-thirds of GDP. Residential investment, spurred on by two consecutive interest-rate cuts from the Fed, showed signs of life at 5.1% annualized growth in the third quarter, up from almost two years of negative reads. Since the third quarter last year, housing investment has grown 0.18%, the first positive read since the end of 2017. U.S. businesses, however, continue to hunker down.

Nonresidential fixed investment, a measure of what businesses spend on buildings and equipment, dropped by an annualized 3% — its worst reading in nearly four years. This was worse than the consensus projections. The Federal Reserve has followed business spending closely this year as an indicator of how confident companies are feeling as they watch the U.S.-China trade war unfold.

The category known as “structures”, which includes offices, hospitals and oil wells among other buildings, showed a sharp 15.1% decline, after an 11.1 per cent fall in the second quarter. This reflected, in part, the drop in global oil prices and consolidation in America's oil patch, where frackers are holding off on drilling new wells. Investment in equipment — which includes aircraft parts — declined 3.8%. The drop in

business investment in equipment is attention-grabbing, but weakness is being exaggerated by problems at aircraft manufacturer Boeing, which was forced to halt sales of the 737 Max after two fatal crashes.

Business spending was the big weak spot — and a potential concern for the economy. This was not only the worst performance since late 2015, but it is also the first back-to-back contraction of more than 1% in business investment since 2009, reflecting the effects from weak global growth, rising trade protectionism, elevated policy uncertainty, a strong dollar, and depressed energy activity.

At the end of October, the Federal Reserve delivered another quarter-point interest rate cut, for the third time this year. The central bank signaled that with this latest move, it has finished easing monetary policy for the time being, pending clearer economic data. The Fed cited the possibility of a preliminary U.S.-China trade deal and the lower risk of a no-deal Brexit as having the potential to increase business confidence. The outcome of both these issues remain uncertain. Meanwhile, this latest cut and the signal that the Fed's rate-setting committee will now pause its easing, come as the central bank is eager to make sure it still has room to act when an economic downturn materializes in the U.S.

Despite historically low unemployment [3.6%], solid wage growth and decent consumer purchases this year, the Fed has now implemented three rate cuts since July. Its target policy range is now 75 basis points lower, at 1.5%-1.75%.

Brazil

Brazil's central bank cut its benchmark interest rate, following the passing of a much anticipated pension reform bill that spurred hopes of a recovery in the country's sluggish economy amid low inflation. The Selic rate hit a new low of 5% after the monetary policy committee approved a cut of 50 basis points following a previous rate cut in July. According to the

central bank the process of reforms and adjustments needed in the economy has advanced, but it emphasized that persevering in this process is essential for the fall of the structural interest rate and for the sustainable recovery of the economy. Some independent forecasters predict that the central bank will slash another 50 basis points at the next meeting in December to bring the Selic rate down to 4.5% by year-end.

The new pension law is expected to save the state \$199 billion over the next decade and is seen as key in shoring up public finances and restoring confidence in the weak economy. The next big reform in the works is a contentious plan to simplify the nation's tax system, with reforms of value added tax and income tax and a reduction in payroll taxes.

The consensus forecasts put Brazil's 2019 GDP growth at 0.9%, improving to 1.1% in 2020, as the economy continues to limp forward from a brutal recession which ended two years ago. Inflation is projected to anchor at 3.3% while borrowing costs are forecast to fall further.

Meanwhile, President Jair Bolsonaro visited China in October where he met his Chinese counterpart, Xi Jinping. The focus of the visit was to encourage Chinese investment in Brazilian infrastructure and gaining additional markets for Brazilian exports. The visit produced several memorandums of understanding, as well as two agreements regarding the export to China of Brazilian thermo-processed beef and cottonseed meal.

The visit did not immediately yield any new or finalized agreements on soybeans, however, despite Brazil already positioning itself as an alternative supplier to the U.S. amid the U.S.-China trade war. This is likely owing to pressure by U.S. trade negotiators on China to increase its purchases of U.S. agricultural products to U.S.\$40 billion-\$50 billion annually, as part of their first phase trade deal. Media reports, however, suggest that China has pushed back on such a high commitment.

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Mr. Bolsonaro also invited Chinese companies to participate in Brazil's upcoming oil and gas "mega-auction"-set for November 6th - and announced that Brazil would soon grant visa-requirement exemptions for Chinese visitors. The visit skirted several contentious issues, such as the potential installation of a 5G network in Brazil by Huawei, the Chinese technology company deemed a national security threat by the U.S. government.

Despite few concrete developments, the visit marked an about-face from Mr. Bolsonaro's anti-China nationalistic rhetoric during his 2018 election campaign. He struck a more diplomatic tone than he did in a recent speech to the UN. He walked back from his previous remarks that China was "buying up Brazil" (particularly its natural resources), and he softened his rhetoric on relations across the Taiwan Strait (he had previously visited Taiwan during his election campaign, angering China).

Closer relations between the two countries are part of a longer trend: China is Brazil's top trade partner, and both sides traded nearly US\$100bn in goods and services in 2018. China-Brazil relations have also turned more harmonious since Brazil's political campaign season, and several Brazilian delegations visited China in January and May. A planned visit to Brazil by Mr. Xi for the November 13th-14th BRICS summit could serve to further cement friendly relations.

President Bolsonaro also visited Saudi Arabia and indicated that he would like his country to join OPEC. Brazil produces enough oil to be a member of OPEC— around as much as Kuwait. It long ago overtook cartel founding member Venezuela to be South America's largest producer.

Brazil is the largest Latin American economy with a population of 202 million and it exports much less crude than Kuwait. It even has to import fuel to satisfy some of its domestic needs. That isn't the only reason Brazil may have to think twice about joining OPEC. Joining a cartel comes with obligations but few rights. On the other hand, if leading members including Saudi Arabia or "OPEC+" allies such as Russia cut back output, non-cartel producers can benefit without sharing the cost of lost exports.

Already facing hurdles attracting foreign investment to its vast offshore fields, Brazil shouldn't add the threat of crimping their future output because of a club it joined. A McKinsey report projects that Brazil can grow its crude output 25% by 2022 and as much as 70% by 2035. OPEC would love to have Brazil, but the feeling shouldn't be mutual.

India

The Indian economy is experiencing a sharp slowdown. GDP is currently growing at 5% (a six-year low) down from 8% as of June 2019. Unemployment is on the rise, from 6% in mid-2018 to 9% last month. Depressed consumer sentiment and tepid investment are the main reasons for the slowdown. Overall, the expectation is GDP growth will at best be in the 5.2% range over 2019-2020.

Lower crude oil prices will have a dampening effect on prices in 2020, but this will be more than offset by even a modest pick-up in domestic demand growth, the lagged effect of interest-rate cuts and currency depreciation in 2019. Consumer price inflation is forecast at 4.1% in 2020, up from an estimated 3.4% in 2019. An expansionary fiscal policy will also contribute to a rise in price pressures. Prices of food and oil will remain the key factors influencing inflationary pressures going forward. Food and beverages have a weighting of around 45% in the consumer price index, and so any volatility in agricultural output will affect price stability.

With a \$200 billion mountain of bad debts the banking system requires massive capital injection and/or privatization to prevent a financial crisis. Tight liquidity in the financial sector is particularly worrisome and a creeping shadow-banking crisis which began in 2018 with the collapse of a finance company has continued. This prompted Standard & Poor's to warn of a rising risk of contagion in the financial sector. Several of India's finance companies have lost more than 50% of their equity value over the past year. Some of these entities are themselves among India's largest bank borrowers. The upshot: a recent report by India's central bank has suggested that the failure of any one of the top five shadow finance companies could trigger defaults in one or two of India's commercial banks. In the six months ending in September, the total flow of financing to businesses fell 88%. Five successive interest rate cuts by the Reserve Bank of India, have failed to pull down commercial lending rates, and in any case, firms are not investing. Consumer demand has leveled off or fallen. Sales of cars and motorcycles have tumbled by 20% or more.

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With the combined fiscal deficit of the federal and the states already at 10% of GDP, and tax receipts falling below expectations, there is little scope for stimulus. Equally, the Indian government will be hard-pressed to intervene in the banking sector to stem the crisis. The government of Prime Minister Modi has a narrow space fiscally to deal with any major financial crisis, given the high combined public sector deficits. In the budget for 2019/20, the government announced plans to provide \$10 billion to help shore up public-sector banks in the fiscal year. If this sum is delivered in full, it would be a helpful in addressing banks' balance sheet problems, but implementation may be a challenge.

The government continues to promise long-stalled structural reforms including removing outmoded labor and land sale restrictions. Such reforms are considered essential if India is ever to begin a Chinese-style industrial economic transformation. In an effort to stimulate the economy, the government has cut corporate tax from 30% to 22% and has introduced a revised 15% tax rate for new manufacturers. While these are welcome and needed reforms, they are unlikely to restore declining domestic demand in the short-term.

The Economist Intelligence Unit believes the economy should begin to regain some momentum in the months ahead. This is supported by a series of measures enacted by government to help boost domestic economic activity, coupled with a low interest rate environment which could spur demand and investment. At the same time, complaints have grown that Prime Minister Modi needs to spend less time promoting Indian Hindu nationalism and instead refocus on economic growth, modernization, removing red tape, creating conditions to attract foreign investment and rooting out corruption.

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Meanwhile, investors are watching cautiously the Modi government's consistent campaign to marginalize non-Hindu minority groups and states within India. That trend, if maintained could act as disincentive to prospective investors/creditors sensitive to tensions which could boil over into ethnic unrest. The Modi government's clampdown in Jammu state and control over disputed Kashmir [with Pakistan], are hotbed issues that serve as prime examples of the Modi's Hindu-centered assertiveness since his reelection

earlier this year. Tensions with Pakistan will be heightened further by the Indian government's revocation of the special status granted Jammu and Kashmir. Shortly after the Indian government announced the revocation, Pakistan downgraded its diplomatic ties with India, and India responded in kind.

This trend together with weakening economic growth are troubling signs which hurts confidence. India needs rapid economic growth just to keep its vast workforce sufficiently employed. The current economic slowdown appears likely to be more prolonged than the government is willing to admit. The consensus is that currently, the economy is being less than competently managed and ethnic/religious tensions will only compound a negative perception of India's country risks.

Chile

Chile is in the midst of its worst political crisis in three decades. What started in mid-October as student-led, anti-government protests against increases in transportation costs, has broadened into a full-fledged revolt against inequality. The intensity of the uprisings reflects deep seated resentment of the status quo. The civil unrest that is unfolding in one of Latin America's richest countries, forced the government of President Sebastian Pinera to announce that it would no longer host the Asia-Pacific Economic Cooperation [Apec] summit.

The Apec summit was due to be held in mid-November and was to include heads of state from member nations, including U.S. and Chinese Presidents Trump and Xi. [It had been expected that a trade truce might have been secured between the U.S. and China at the gathering]. Chile has also pulled out of hosting a UN climate change conference, COP25, which was due to be held in December. Chile had hoped to use both gatherings to showcase to the world its achievements of political stability and openness to global com-

merce built up over the past three decades. Chile has been an anchor of stability in Latin America from both an economic and political perspective, reducing poverty, tending to democratic institutions and achieving steady economic growth. The country is also considered a leader in global trade matters. The sudden turn of events has been stunning.

Curfews and a state of emergency were recently lifted to help ease the rioting. This was followed by a cabinet reshuffle which saw the departure of some of President Pinera's most loyal ministers. Despite bringing younger and more moderate figures into his cabinet and reducing the military's presence from the streets, the unrest has persisted. Two weeks of protests against a 3.7% increase in bus and metro fares turned violent, exacerbated by what many criticize as a poor and insensitive initial response to the crisis. The president's approval ratings are at an all-time low of 14%.

At least 20 people have died so far and 6,000 arrested amid protests, looting and arson. Economic losses are estimated in excess of \$200 million and counting. Demonstrators have continued to set buildings on fire and to vandalize train stations, and there are few signs that the situation is yet under control. It also unleashed larger-scale, peaceful protests. Miners, health workers and teachers went on strike, there were traditional pot and pan protests in residential areas, and truck drivers blocked roads to protest against electronic highway toll charges. Most dramatic was a peaceful protest in late October of more than one million people in the capital, Santiago and other cities to demand economic and political change.

Chile has long been considered one of the most prosperous and stable economies in Latin America, after a sustained period of growth (since the fall of Augusto Pinochet, the dictator in 1990). During the period poverty fell from 40% to 10%. With higher GDP per head and lower poverty levels than other major economies in the region, Chile has seemed one of the least

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likely countries in Latin America to face social upheaval. In a recent survey of public attitudes in the region, Chile topped the economic ranking (with 26% of respondents describing the economic situation in their country as "good" or "very good". However, the current fallout shows that Chile is not immune to public discontent that has plagued the region.

They come as the region is convulsed by turmoil. [Rioting forced Ecuador's government to reinstate fuel subsidies. Peru's president has dissolved the country's congress. Protests hit Bolivia, where the president is suspected of trying to steal an election. Populists were returned to power in Argentina in October; the country is in recession and faces a growing liquidity/debt crisis. Mexico and Brazil are run by populists].

After taking a hardline initially, President Pinera has since taken a more conciliatory position by announcing a series of reforms and pledging to refocus on the issues raised by the protesters with his new cabinet. These include an increase in basic pensions, a higher minimum wage, a waiver on recent transport and electricity tariff increases, and the introduction of an insurance scheme to cover medicines. However, the measures announced so far have been perceived as insufficient in response to an ever-growing list of demands. Some 80% of Chileans view the proposals as inadequate, according to a recent poll. This poses serious economic, political and governability challenges, with protesters viewing Mr. Pinera (a billionaire) as a symbol of the political elite.

The economic policy consensus that has dominated Chile for the past 30 years, and that's been maintained by governments on the left and the right, is under strain. The traditional political parties that have upheld this policy are under threat from increased polarization. Political reforms intended to enhance participation of smaller parties have, since the 2017 general election, led to legislative gridlock which is unusual for Chile, heightening the sense that the Pinera administration, and politicians in general, can get nothing done.

President Pinera will hit the halfway mark of his four-year term in March 2020. The political implications of the riots and demonstrations will be far-reaching. Without a comprehensive plan and a turn-around in the government's attitude toward the many issues in contention, President Pinera may not have the ability to finish his term. More problematic is that if the crisis is not handled with wisdom, the populace could drift toward radical left-wing politics in search of alternative solutions.

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FCIA's Deals Of the Month

Single Buyer Policy: \$25,000,000 limit of liability in short-term coverage supporting export to Brazil in petrochemical sector.

Multibuyer NonCancelable Policy: \$30,000,000 policy Limit of Liability supporting domestic sale of food products. Policy was acquired for risk mitigation and financing purposes.

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