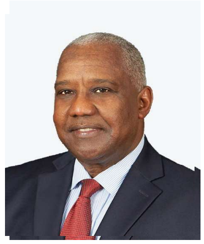
Major Country Risk Developments
October 2019



By Byron Shoulton

USA

The 2019 U.S. GDP growth outlook is projected at 2.2%, slowing to 2.0% in 2020. With global demand trending below that of the U.S., the dollar continues to play the lead role among preferred reserve currencies [dollar, euro, yen, sterling, Swiss francs]. The U.S. has been attracting significant inflows of capital.

The Federal Reserve cut interest rates three times over 2018- 2019. The Fed remains under political pressure to cut rates further to ensure that a recession is avoided for as long as possible. The Fed could cut rates further in 2020 if data indicates the economy is slowing and requires such a stimulus. Meanwhile, unemployment fell to 50-year lows of 3.5%, while wage growth has begun to strengthen. These trends are normally supportive of continued strong consumer confidence. However, consumer confidence was weaker than expected in September 2019, falling 9.1 points to 125.1, while businesses have grown increasingly concerned over the trade war with China. The trade war's dampening effect on U.S. exports [combined with weak consumption growth in Europe, Asia and Latin America] is starting to affect new business investment in the U.S. Consumer spending appears to be slowing, while businesses cut back on investment in August and September – signs that a wobbling global economy and rising tariffs could sap U.S. economic momentum. Also, regional economic indicators suggest that the financial health of the U.S. Midwest is waning, as trade tariffs start to take their toll on sectors from farming to manufacturing. The U.S. manufacturing sector contracted for the second consecutive month in September, falling to its lowest level since the recession.

As trade uncertainty continues to weigh on business confidence, the implications for the economy as a whole is tilting toward the negative. For example, loan delinquencies and bankruptcies are rising in the Midwest, according to data from the American Farm Bureau Federation. Meanwhile, the Federal Reserve Bank of Chicago's Midwest Economy Index was in negative territory over five consecutive months. The regional reading on business confidence fell to its lowest quarter-end level since the September quarter of 2009. Consumer spending has been the main engine of U.S. economic growth. Even as GDP expanded at a slower 1.7% in the third quarter [from 2% in the second quarter], it was the American consumer that helped spur the economy, with the strongest spending growth in four-and-a-half years. However, the latest batch of data suggest the longest U.S. expansion since 1854 is losing momentum as Americans tightened their purse strings.

The likelihood of a de-escalation in the trade conflict before the U.S. presidential election in November 2020 is slim, even with the promise of a revival in talks between both the U.S. and China. Even if President Trump does not win a second term, it is not clear how quickly or easily relations between the U.S. and China can be repaired. There is an increasingly bipartisan view in the U.S. that the two countries are engaged in strategic rivalry, particularly in the field of information and communication technology, and growing nationalistic sentiment will make it difficult to offer meaningful concessions on both sides.

As conflict between the world's two largest economies hardens, other countries will come under increasing pressure to choose sides. This is already happening with the EU, Canada and Australia all being dragged into a technology trade war between China and the U.S. over the role of Huawei, the Chinese telecommunications company, in the rollout of fifth-generation (5G) mobile networks. The end

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result could be an effective split in the global trade system between countries leaning towards China and those allied with the U.S. A slowdown in global trade remains the most significant drag, as demonstrated by contraction in new export orders which began in July 2019. The overall sentiment remains cautious regarding near-term growth amid renewed fears about domestic and global growth.

Meanwhile, voices in the U.S. Congress are considering how to restrict U.S. pension funds and venture capital firms from investing in Chinese technology companies, and U.S. regulators have already moved to clamp down on Chinese venture capitalists from investing in Silicon Valley. Chinese venture capital investment in the U.S. fell to four year lows in 2019, amid heightened U.S. scrutiny over national security concerns. Moreover, in July 2019 a U.S. federal court found several large Chinese banks in contempt of court for failing to comply with earlier U.S. subpoenas regarding alleged violations of sanctions on North Korea. One of those banks has been issued an administrative subpoena under the U.S. Patriot Act, which could set in motion steps to cut off the bank's access to the U.S. financial system. What started with an outbreak of tit-for-tat tariff increases between the U.S. and China in 2018 is developing into a much more profound rupture in their bilateral economic relationship.

Separately, The New York Federal Reserve was forced to tamp down an unexpected bout of turbulence in money markets that caught officials and investors off guard. A sudden shortage of cash caused interest rates to spike unexpectedly on very short-term loans banks make to each other overnight, called repurchase or "repo" agreements. The Fed's response, flooding the system with temporary funding, soothed markets. However, many believe the Fed was caught flat-footed. The Fed is facing urgent calls to find a permanent fix to these short-term funding strains and to avoid another bout of volatility at the end of the year when demand for cash is expected to rise again. Among options being considered: The Fed to announce asset purchases [Treasuries] through a standing repo facility, which would pre-commit to conducting repo operations to serve as a backstop against unusual demand spikes in money markets. Another suggestion: aggressive cuts to interest rates.

Mexico

Regaining economic growth in 2020 is the top priority for the government of President Manuel Lopez Obrador [AMLO]. The ratification of the US, Mexico, Canada Agreement [USMCA] will be essential in confirming the terms and rules of engagement for continued trade between the three countries going forward. Ratification of USMCA also would remove any lingering uncertainties or doubts that may give creditors and prospective investors cause to withhold or pause doing business with or in Mexico. The U.S. Congress recently gave strong reassurances that ratification of USMCA remains a top priority and that it expects to move forward toward ratification once certain safeguards to U.S. labor are included as concessions.

Mexico's central bank [Banxico] lowered its policy interest rate to 7.75% at its latest policy committee meeting. The rate cut came just days after a similar move by the U.S. Federal Reserve, which Banxico has been closely tracking as part of its own monetary easing cycle. Continuing the theme of recent months, the central bank noted slower growth which persists and has resulted in in downward pressure on inflation [which appears stable at 3%]. Mexico's domestic economy has been stagnant throughout 2019, but the outlook is more positive for 2020. Notwithstanding, the central bank has warned about the risk of external volatility, possibly driven by threats from the U.S. to impose trade tariffs or other protectionist measures – as happened earlier in 2019- which could have an impact on the currency exchange rate. The impetus for further rate cuts in Mexico will remain, particularly if the U.S. Fed makes further moves in that direction.

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Recently released data confirmed a major slump in fixed capital investment and indicates that private consumption remains flat. Although the decline in fixed capital formation was considerable, the weakness of private consumption is more concerning as it is a much bigger contributor to GDP growth. Since 2018, GDP has averaged virtually zero growth in quarter-on-quarter terms; which corresponds with much weaker private consumption. Despite a sharp rise in consumer confidence after the 2018 election, an increase in spending has not materialized. There are still questions over whether the economic slowdown has bottomed out and could turn around in the months ahead, with the benefits from monetary easing. Generally, the fiscal outlook remains fairly hawkish. The risk of a U.S. slowdown also weighs on Mexico's 2020 economic outlook. Approximately 80% of Mexican exports are to the U.S.

On the political side, monetary authorities stress the need to reduce investment uncertainty and address the deterioration of credit ratings both for the sovereign and for Pemex, the state-owned oil firm. Pemex recently wrote-off $5 billion of its debt stock after a large capital injection by the Mexican government. The Mexican 2020 budget includes $8.6 billion in financial support for Pemex, considered the most highly indebted oil company in the world. The capital injection was used to repurchase bonds due between 2020 and 2023 with a coupon of between 4.625% and 5.37%.

Despite the reduction of its short-term obligations, the buyback represents one-third of Pemex' total liabilities of over $14.7 billion that become due between now and 2023. Although credit rating agencies have welcomed the debt buyback, they emphasize that it does not fundamentally alter Pemex's precarious financial position or reduce the considerable resources needed to ramp up crude exploration and production.

The government has also announced plans to reduce the company's high tax burden, which is estimated at around 80% of its earnings, freeing up additional resources for investment. Additionally, Pemex is moving to speed up the incorporation of 2 billion barrels of oil reserves to the country's stock by the end of 2019. So far, 1.6 billion barrels have been added during 2019 as a result of drilling 52 new wells, nearly triple the total of the previous year. The annual rise of 2 billion barrels of crude is set to be the largest recorded in a decade.

Looking ahead, the expectation is that investment in export-oriented sectors will increase and boost the external sector's contribution to overall growth. As a share of GDP, exports have risen from 12.5% [before the implementation of NAFTA] to 39% of GDP in 2018. Among these sectors, manufactured goods exports have risen from an average of 25% of the total in the 1980's to almost 90% in 2018.

However, despite Mexico's extensive network of free-trade agreements, which provide access to over 70% of the global marketplace, 80% of export sales go to the U.S. The expectation is for greater export diversification through investment in logistics and more proactive government policies to help producers move up the value chain and develop links with Asia and Europe, as well as Latin America. Even so, Mexico's economic fortunes will remain closely tied to those of the U.S., given geographical proximity, deep economic linkages and prospects for further cultural integration owing to the large numbers of U.S. citizens of Mexican descent.

Turkey

Turkey's Treasury and finance minister has set an ambitious GDP growth target of 5% for 2020. This compares with a revised 2019 growth forecast of 0.5% [down from a previous target of 2.3%]. The economy faced various stress tests over the past twelve months. GDP growth of 1.6% in the first quarter of 2019, was followed by a contraction of 1.5% in the second quarter. The recent contraction followed declines in economic activity in 2018 when real GDP contracted by a cumulative 4%- in the aftermath of a 30% depreciation of the Turkish lira against the U.S. dollar.

Consumption (which accounts for approximately 60% of Turkish GDP) and investment spending were hit by a number of factors; including weak confidence, soaring inflation (caused by the currency depreciation), rising interest rates and high debt burdens. A significant contraction in imports helped to prevent a greater decline in real GDP over the last 18 months.

Further economic declines in 2019 were cushioned by a package of expansionary economic policy measures, including a 26% increase in the minimum wage; reduced tax rates on durable goods; cuts in utility prices; as well as debt refinancing and restructuring. In addition, persistent government pressure on state-owned banks to boost lending has contributed to a pick-up in private consumption and hence to GDP growth.

Continued contraction in imports is expected to contribute positively to real GDP growth in the months ahead. Exports of goods and services narrowed on the back of global trade weakness and slower growth in the euro area. An expected decline in consumer price inflation, plus lower interest rates, expansion of consumer loans, a recovery in non-financial corporate lending, depressed demand for imports and export growth (including services) are all supportive of a pick-up in GDP growth in 2020.

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Recently, the economic confidence index improved to 87.1 points- the highest level recorded in 12 months. The pick-up in confidence reflects the lowering of interest rates, lower inflation and the onset of a steadier lira. The central bank cut policy interest rates sharply in July 2019, causing banks to reduce their deposit and lending rates. The 2020 growth outlook has been revised downwards to 3.5% [from 5% previously], reflecting the assessment that a recovery while robust, will be far from causing the economy to overheat. The International Monetary Fund (IMF) observed that while efforts to expand bank lending is welcome, these should be limited in scope and should ensure that the resulting credit is channeled to viable borrowers. The Fund warned Turkish authorities to stand ready to rein in excessive and /or imprudent credit growth at the first sign of excess.

A relatively loose fiscal policy resulted in a budget deficit of 2% of GDP in 2018. In view of the expanding government budget deficit in 2019; and considering corrective measures that have been implemented, the 2019 budget deficit was revised to 2.8% from 2.3% of GDP. Looking ahead the 2020-23 projections are that conservative on-balance-sheet spending will keep the budget deficit at around 2.1% of GDP per year on average. Meanwhile, the lira has recovered as market pressures have abated. Import compression and a strong tourism season have led to a remarkable current account adjustment. The forecast is for the current account deficit to contract to the 2.8% of GDP range in 2020-23 [compared to current-account deficits in the 4-5% of GDP range in recent years].

Foreign direct investment (FDI) inflows to Turkey were $12.9 billion in 2018. Forecast of FDI inflows during 2019-23 is an average of $14 billion per year.

The Turkish Investment Support Agency reports that the financial services represented the largest volume of FDI over the past decade, followed by manufacturing, energy, and information and communications technology services. By region the EU has been the largest source of FDI, followed by North America and the Gulf countries, while the share from Asia has been rising. This trend is expected to continue over the next few years.

Turkey has traditionally had a liberal foreign-exchange system. Responsibility for exchange controls rests with the Under-Secretariat of the Treasury. Individuals and companies are able to open foreign-exchange accounts and transfer amounts abroad without restrictions. However, the Under-Secretariat of the Treasury must be informed within three months after export of capital, except in transactions involving imports, exports or intangible assets.

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The relationship between the U.S. and Turkey has been characterized by tensions in recent years. Thorny issues include conflicting positions regarding the Turkey's Kurdish minority; differences over the two countries relations with Iran; Turkish acquisition of Russian missiles; and the delivery of U.S.- made fighter jets to Turkey. Given the wide scope of disagreements between both countries, companies should remain prepared for the possibility of more lira volatility and U.S. sanctions against Turkish officials cannot be ruled out.

Against the backdrop of the recent weakness in the Turkish economy, the political opposition is putting strong pressure on President Erdogan and his government. Following the severe currency crisis in 2018 the opposition's performance in local elections in May 2019 was strong, causing the political scene to be in a state of flux. There is widespread speculation surrounding the formation of new political parties by former heavyweights of the ruling AKP, that could further erode public support for Erdogan and the alliance between the AKP and the hard-right Nationalist Action Party (MHP).

Turkey's next presidential and parliamentary elections are not due until June 2023. Meanwhile, several recent expulsions of former allies and ministers from the ruling AKP occurred in response to their open criticisms of the government and President Erdogan's policies. Several of the expelled are reportedly preparing to form a new political party.

President Erdogan brands his former allies as "traitors" and signaled that he will continue to respond to dissent and opposition with a heavy hand. Alongside the high-level expulsions from the AKP, the government also dismissed three elected mayors from the pro-Kurdish People's Democratic Party (HDP) in the south-east of Turkey, owing to their alleged links to the PKK, the Kurdish party. An Istanbul court recently sentenced the provincial head of the main opposition Republican People's Party (CHP) to ten years in prison on a range of charges, including spreading terrorist propaganda and insulting the president and the Turkish state. Erdogan's government controls much of the media and retains a tight grip on power.

A crackdown on undocumented immigrants, including Syrian refugees began in early July 2019. The crackdown followed the defeat of the ruling AKP in the Istanbul mayoral election in June. The large presence of Syrian refugees in the city – about 550,000 are registered in Istanbul- but estimates suggests that twice that number live in the city- contributed to the decline in the party's popularity, which had already been suffering due to the economic downturn and soaring unemployment. The newly elected mayor of Istanbul of the opposition CHP, repeatedly criticized the AKP's management of refugees and took advantage of the electorate's resentment over the perceived burden of Syrian refugees.

The Turkish electorate's discontent has been fueled by refugees' competition for low-wage jobs, their allegedly preferential access to public services, and the perceived disparity between assistance provided for Syrians and equally vulnerable Turkish citizens. Until recently, the AKP's efforts to ease public discontent remained limited. However, Turkey's strained economy over the past eighteen months, has made it increasingly difficult for the AKP to contain negative sentiment towards refugees by calling on the "Muslim compassion" of its electorate. Turkey lacks a comprehensive integration plan for approximately 3.6 million Syrian refugees on its soil. Instead, Syrian migrants are given temporary protection status, which can be revoked collectively or individually. Turkish citizens across the political spectrum overwhelmingly want to see Syrians return to their country of origin. The AKP government is thus likely to adopt an increasingly strict-and at times hostile- stance towards Syrians in Turkey in an attempt to benefit from the electorate's grievances.

Argentina

The Argentine government recently presented a draft budget for 2020. And despite recent economic and political setbacks, the government has reiterated its commitment to fiscal adjustment measures in order to produce a primary surplus of 1% of GDP in 2020. The budget envisages inflation slowing only modestly, from 54.5% at end-2019 to 34.2% by end-2020. It also assumes an average exchange rate of Ps67.1:U.S.$1 in 2020, up from Ps47.9:U.S.$1. Private estimates assume a weaker peso, but these estimates are subject to revision if recently introduced capital controls are strengthened or expanded.

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Meanwhile, recent quarterly data show inward foreign direct investment falling by 61%; and projections are that FDI flows will likely remain subdued. There have been large divestments of foreign portfolio capital mostly related to bond sell-offs. Argentina's overall financial account was recently bolstered by a $10.8 billion disbursement from the IMF as part of a $57 billion standby arrangement with the government. Nonetheless, this did not prevent a decline in foreign reserves of $2 billion.

Official estimates project economic contraction of 2.6% in 2019. The government's assumption is that the ongoing collapse in fixed investment will bottom out in 2020, with a full-year contraction of 4.9%. Private forecasts project a contraction in GDP of 0.5% in 2020, driven by a double-digit decline in investment for the year. The government is looking to reduce primary spending in 2020 by 1.2% of GDP, through across- the-board cuts to budget items. With no new tax measures introduced, and no major privatizations planned, the government expects to increase central government revenue by just 0.2% of GDP. This revenue gain will come entirely from non-tax resources, including property income (where revenue flows are largely dollarized). Consequently, the burden of fiscal adjustment will fall mostly on spending cuts. It will be difficult to achieve these targets.

Argentina imposed capital controls in 2019 and requires exporters to repatriate foreign exchange earnings within five days. The proceeds must then be converted to pesos. So far, there are no indications payment restrictions will apply to trade obligations. The government also indicated that it will look to restructure its stock of foreign debt ($101 billion), including $57 billion owed to the IMF. Argentina is seeking to extend the maturity of its debt (denominated in both local and foreign currencies) hoping to provide stability for the peso as concerns grow about the country's political stability and its ability to repay its debts. The new measures are part of the embattled Macri government's strategy to prevent further capital flight, stabilize the peso and bring prices under control. The currency crisis has fueled inflation, already one of the highest in the world. The outlook is for inflation to hit 60% by year-end 2019.

The debt restructuring initiative seeks to extend the maturity for short-term debt [issued in Argentina as well as bonds issued abroad] without reducing principal or interest. The government also proposed that the IMF restructure the $57 billion bailout package agreed to with Argentina in 2018. The original agreement had repayment of IMF debt beginning in 2021. The IMF is assessing its options but remain mindful that Argentine authorities must address liquidity needs and safeguard the country's foreign exchange reserves. It will be left to a new government to renegotiate the existing agreement with the IMF.

Opposition Peronist presidential candidate Alberto Fernandez is the favorite to win the October 2019 election. Mr. Fernandez partly blames the IMF for the country's economic stagnation, high inflation and capital flight - resulting from austerity measures implemented with the IMF's backing. If he becomes president, Fernandez is likely to demand significant changes to the existing IMF agreement. He will also want changes to the draft budget, to better reflect the priorities of the incoming administration.

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Argentina's major creditors are cool toward the government's plan to delay payments on its debt. Nonetheless, they are fully aware that debt reprofiling is needed to alleviate the country's immediate funding pressures. One proposal is to postpone payment on $47 billion of short-term local debt for up to six months while pursuing "voluntary reprofiling" of $50 billion of longer-dated debt, the majority of which is owned by foreign investors. The government plans to delay the repayment of $44 billion of loans already disbursed by the IMF. Most creditors remain cautious and seek clarity on what economic policies the next government will pursue and what relationship Argentina will have with the IMF going forward.

Investors are broadly resigned to the rescheduling of short-term debt, given that approximately $30 billion in debt falls due over the balance of 2019; while foreign exchange reserves are estimated at around $10 billion.

Argentina's nearly 100% debt to GDP ratio is unlikely to change significantly anytime soon. Investors are broadly resigned to the rescheduling of short-term debt, given that approximately $30 billion in debt falls due over the balance of 2019; while foreign exchange reserves are estimated at around $10 billion. About 80% of Argentina's debt is denominated in dollars.

Meanwhile, the presidential front-runner, Mr. Fernandez has held meetings with Argentina's trade union federation and the manufacturers' association, in what appears to be the start of negotiations on a social pact that he plans to launch at the start of his expected term of office. The pact is likely to include a price and wage agreement, which would see gradual wage increases and a commitment to at least partial price freezes. Mr. Fernandez hopes that wage increases will boost consumption; but relying on cash-strapped businesses to bear more losses to boost consumption will further subdue business investment.

Assuming that capital controls remain in place and there are no further sharp declines in the currency, inflation is expected to come down in 2020 from this year's extraordinarily high levels. However, inflation is unlikely to fall below 20% in the medium term, as monetary policy will be loose and fiscal spending will be higher than under a Macri administration. A lack of policy clarity could lessen confidence in production and private property rights under a Fernandez administration. Price controls will likely be expanded and newly imposed capital controls will likely be tightened over the next year.

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