

Major Country Risk Developments December 2021



By Byron Shoulton

Overview

Just as it seemed the global economy was beginning to move toward a steady recovery, a new strain of the Coronavirus (Omicron) has surfaced in several countries and continues to spread. While scientists are still uncertain about the likely broad impact of this new strain, we expect it will dampen the outlook for economic growth in 2022. The presence of this new variant, amid ongoing global inflationary spikes have already altered the U.S. Federal Reserve's timetable for withdrawing its asset purchase program; and forced the central bank to take a more assertive stand to begin tightening monetary policy. It now appears that current ultra-low U.S. interest rates will begin to see increases early in 2022 rather than later in the year.

Continued strong global demand, coupled with ongoing supply shortages and rising energy costs have led to sustained high inflationary pressures, which could dent consumer and business confidence in 2022. Many forecasters expect factory output could be negatively impacted around the world as new cases of the virus spread. While complete lockdowns are unlikely, renewed travel bans and strict testing protocols are already dampening vacation travel (flight and hotel cancellations are up since the new variant was identified). We believe the need for more people to get vaccinated has become more real [witness a jump in vaccinations since Omicron]; and many who were previously reluctant will now get the jab. While it is still early to be certain, we suspect that Omicron's impact on the global economy and trade is likely to be smaller than with previous variants. Meanwhile, shipping goods across the world's main trade arteries remains expensive and delivery remains slow. The OECD has warned that the Omicron variant threatens to intensify imbalances that are slowing growth and boosting inflation.

The Bank of England (BOE) has opined that existing market conditions merit raising interest rates at the central bank's next Monetary Policy Committee (MPC) meetings this month or in February 2022, despite uncertainty over the Omicron variant. The British central bank says it now believes that the recovery has matured, and that inflation is likely to remain persistently high in the months ahead. In fact, some members of the BOE Monetary Policy Committee have suggested that the emergence of the Omicron variant could mean that inflation remains higher for longer than expected – if it prevents consumers from switching spending patterns from goods to services; and help prolong disruptions to global supply chains.

Meanwhile, the **People's Bank of China** (the central bank) reduced the amount of money banks must hold in reserve, in a move meant to inject liquidity into the financial system to help stimulate fresh economic activity. This signals Beijing's concerns about the slowing Chinese economy. Amidst a sharp slowdown in the heavily indebted real estate sector, and a nationwide power shortage, the potential threat of the Omicron variant has added to concerns. The central bank's recent move [which takes effect December 15th] would unleash \$188.3 billion into the financial system. While the central bank says it will not change its monetary-policy stance, the released liquidity will be used by banks to repay loans issued by the central bank to lenders. It was the second such move this year, after an earlier one in July meant to inject liquidity into the financial system. The measure signals Beijing's growing concerns about the growth outlook of the world's second-largest economy, which has been battered in recent months by multiple developments.

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China’s central bank says it has entered an easing cycle, and that it will move toward supporting the economy over the next six-twelve months. However, the central bank assured markets that it will maintain a stable monetary policy and avoid flooding the economy with stimulus. The International Monetary Fund (IMF) confirmed that China, as a vital engine of global growth, is taking actions to support “high-quality growth” that will help not only China but the world economy. China also agreed to channel \$10 billion of its IMF allocation to support African economies.

Separately, a new Chinese data-security law will make it harder for foreign companies and investors to get Chinese information, including about suppliers and financial statements. Several providers of ship locations in Chinese waters stopped sharing information outside the country, making it difficult for outsiders to understand port activity in the country. Chinese authorities have restricted information on coal use, purged documents related to political dissent cases from an official judicial database, and shut down academic exchanges with other countries. Companies and governments are left trying to figure out how to effectively engage with and gain essential information from this large and influential economy going forward.

In **Algeria**, the economy is gradually recovering from the initial impact of the pandemic and the 2019-20 oil shock. The health crisis has eased, most containment measures have been lifted and domestic production of vaccines is supporting immunization efforts. With the rebound of oil and gas production and the rebound in prices, growth has resumed, but the

outlook is still uncertain. Macroeconomic stability is under pressure and a broad policy revision is needed. These include market reforms that seek to build a more diversified economy and a more inclusive growth model. The country has outlined in its Government Action Plan unveiled in September, wide-ranging reforms toward gradual fiscal consolidation supported by monetary tightening and exchange rate flexibility. The government has developed plans to accommodate need for higher health spending and fiscal support measures to support the recovery.

The IMF has noted that Algeria has many untapped sources of growth and jobs. Developing them requires a transformation of the economy and diversifying it away from over-reliance on hydrocarbons. The recovery from the pandemic provides a unique opportunity for Algeria to rebuild resilience and harness the potential of its youthful population.

Peru’s new government’s anti-mining stance could change the country’s business operating environment over the next two years. The administration of President Pedro Castillo has taken a critical view of Peru’s mining sector, even threatening to nationalize firms. This helped Mr. Castillo gain strong support in areas where mining is a major industry. Although since coming to office Mr. Castillo has moderated his rhetoric and policies, his government continues to criticize the sector arguing that it does not pay enough taxes or royalties. The government has also criticized the sector for its effects on the environment and not being sufficiently supportive of local communities.

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A long-delayed \$1.4 billion Tia Maria copper mine has been cancelled by the government owing to local

opposition to the project. Anti-mining protests have also increased. By late October protests against the Antamina copper mine (the largest in Peru) led to road blockages, forcing the firm to temporarily halt production. The forecast is for anti-mining protests in Peru to remain elevated in 2022-23 as coronavirus mobility restrictions are eased and protesters see an opportunity to negotiate more favorable terms with mining companies owing to high commodity prices. Still, it is not expected that these protests will affect production at mines. Mining companies operating in Peru have been urged to foster constructive relationships with local communities as well as invest in security to protect their facilities. The business environment is likely to become increasingly strained going forward, without a meeting of the minds between the companies and the government.

Argentina

Economic activity rose by 1.1% in October. The stronger than expected results builds on consistent sequential growth since June and puts activity back above pre-pandemic levels. However, there are few reasons to think the recovery is self-sustaining, and the consensus is that the country could see a growth slowdown in 2022 to 2.5% (from an estimated 7.5% in 2021).

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The manufacturing sector especially has seen strong growth in recent months for two main reasons. First, demand for agricultural machinery has increased substantially, as farmers have ramped up investment in response to roaring soft commodity prices. Second, car production has been on an upswing on the back of solid external demand. Looking ahead however, the forecast is for manufacturing growth to taper off. The pace of new agricultural investment is likely to

slow given rising costs of inputs (including fuel) and government restrictions (such as recently introduced controls on corn exports). Also, the auto sector will face new headwinds as demand from Brazil (Argentina's largest trading partner) is pared back.

Another major contributor to growth has been commercial activity: as the pandemic stifled services consumption, a lot of domestic demand shifted towards goods – a trend made possible by rapid expansion of e-commerce. However, as the economy is gradually opened up, merchandise trade is likely to normalize, while other services – including entertainment, travel, and tourism- pick up in the second half of 2022. The big question is whether growth momentum can be sustained. On that front there is pessimism. The headline growth numbers belie a complex macroeconomic landscape in Argentina, riddled with price distortions, exchange-rate misalignments, and a huge fiscal imbalance. These issues can only be addressed through painful policy corrections that hamper domestic demand, a consideration that is already weighing on consumer and business confidence.

The year 2022 promises to be a make-or-break year for Argentina. The policy decisions taken will determine whether the country sets itself on a path towards sustainable long-term growth or whether it remains trapped in yet another boom-bust cycle. This will be front and center in the government's ongoing negotiations with the IMF over a new lending agreement.

For the next few months much will be centered on negotiations between the Argentine government and the IMF over the terms of a new lending arrangement. In the context of ever-growing macro-economic imbalances, a burgeoning repayment schedule and a precarious foreign exchange reserves position, there is a pressing need to obtain fresh external financing under an extended fund facility. The main obstacle to a new agreement is a lack of political will on the part of the ruling left-wing Peronist coalition. Having suffered a heavy defeat in the November 14th mid-term elections, the sitting government faces an

uncomfortable recalibration that will pit its moderates against its left-wing hardliners.

The Peronist government has asked for a number of concessions -including a reduction in IMF surcharges and debt relief in exchange for green investments – but the IMF has made it clear that it cannot agree to these. Furthermore, the Argentinian authorities have repeatedly stated their unwillingness to balance the budget by slashing public spending, which is likely to be a non-starter for the Fund.

The growing consensus is that the ruling Peronists will ultimately adopt a pragmatic approach, mostly out of economic necessity.

One take is that the government’s aggressive posturing is part of its negotiating strategy; it took a similar approach with private creditors during debt-restructuring negotiations in 2020. Nevertheless, the gulf between Argentina and the IMF over the terms of an agreement is considerable.

The growing consensus is that the ruling Peronists will ultimately adopt a pragmatic approach, mostly out of economic necessity. Some recent developments bear out this view. In his post-election address to the nation, the president, Alberto Fernandez, signaled his intention to build a broad-based consensus on economic policy and enter a new EFF. That sentiment was reiterated by the economy minister, who expressed his desire to complete negotiations with the IMF by year-end 2021. Nevertheless, at this point prospects for a speedy resolution are dim.

Any resulting deal will be crucial in determining the contours of the policy framework for the country – at a time when the Argentine authorities will have to make difficult choices around issues such as fiscal and currency reform. The expectation is that the Argentine government will commit to an IMF-backed structural adjustment program, largely because it has no other sources of external financing.

Argentina’s currency risk is clearly rising, as indicated by a widening black-market premium for U.S. dollars – now at more than 100%. Addressing the imbalance between the demand and supply of pesos – in a manner that is both orderly and sustainable over time- will be one of the biggest challenges for policy-makers in the coming months. The expectation is that the Argentinian monetary authorities will engineer a controlled devaluation of the peso in the first half of the year, before reverting to the de facto crawling-peg framework that was in place throughout 2020.

In the current environment there continues to be considerable uncertainty about the extent to which the Fernandez administration will embrace market-friendly reforms. A major risk to the currency outlook, which could materialize if the government abandons an IMF deal, is that policymakers attempt to sidestep any politically difficult reforms and instead seek to alleviate balance-of-payments pressures by formalizing a system of multiple exchange rates. As empirical evidence suggests, that move would only worsen price distortions and generate huge efficiency and welfare losses.

Given extremely tight budget constraints and a reluctance to dial back spending, the government will look to raise revenue in order to bolster public finances. Taking into consideration the policy preferences of both the government and the IMF, we believe that the following tax reforms are likely to be pursued in 2022: Wealth tax – In 2021 the government introduced a wealth tax on the richest Argentinians. Although the tax was supposed to be a one-off measure, we believe that it is likely to be made permanent, given that it boosted state coffers by 1% of GDP.

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Corporate tax reform - In accordance with the first pillar of a recently signed global tax deal, the government will tax the largest multinational companies on profits derived from operations carried out in Argentina. In practice, this will largely affect tech giants, such as Apple, Amazon, Google, and Meta Platforms, Inc. (the recently renamed Facebook).

Despite the support of booming soft commodity prices, there has been increased currency speculation in recent weeks, amid strong domestic market speculation about a post-election devaluation. We do not expect depreciation pressures to subside until an IMF deal is signed (we assume that will happen in the first half of 2022).

The peso stood at 100:US\$1 in November and is therefore already approaching the authorities year-end target of 102:US\$1. There is a strong risk that sustained depreciation pressure prompts the authorities to allow the (heavily managed) currency to weaken substantially more by year-end, given that the central bank has a limited stock of foreign exchange reserves with which to manage the official peso.

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An ongoing rally in commodities exports and a competitive currency suggests that the current account will not be a source of balance of payments risk any time soon. The main cause for concern will be the financial account, which will come under strain as a result of rising external debt-service commitments, extremely weak foreign direct investments (reflecting the poor business environment and complexity of doing business in Argentina) and capital flight. All of this means that the foreign exchange reserves position will remain under stress and will only be partly relieved by the receipt of IMF funds.

Brazil

Consumer inflation continues to climb in Brazil. In November prices rose in all nine categories of goods and services, lifting the 12-month figure to 10.7% – the highest level since February 2016. This was more than double the central bank’s mid-point target rate of 3.75%. Despite aggressive monetary policy tightening since March, there is no expectation that inflationary pressure will ease before mid-2022 at the earliest. The economy entered a technical recession in the third quarter 2021 as the surging inflation choked off the emerging recovery from the pandemic. The economy contracted by 0.1% in the quarter.

According to Brazil’s national statistics agency (IBGE) the most significant price increases were in the transport and housing sectors. A rise in commodity prices and a weaker currency fueled inflationary pressures in both segments. In the transport segment, energy prices jumped by 6.6% in November, leading to a whopping cumulative increase of 48% year on year. In terms of housing, prices of cooking gas and electricity were behind the increase. However, even despite persistent pressures stemming from the impact of drought on hydropower supply, the pace of electricity price growth decelerated from October (when prices rose 4%) after local electricity distributors adjusted prices.

In an attempt to rein in inflation and support the weakened Real, the central bank started an aggressive monetary-tightening cycle in March.

The latest data release reinforces the signs pointing towards higher than expected inflation for the year. Producer prices were up by 24.1% in the year to September, on the back of higher input costs driven by a weaker Real and supply-chain disruptions. The government faces rising discontent over soaring costs for everything from gas to meat. In an attempt to rein in inflation and support the weakened Real,

the central bank started an aggressive monetary-tightening cycle in March. The expectation is that the monetary authorities will raise the Selic policy rate (currently 7.5%) at the next monetary policy meeting, scheduled for December 7-8, and then to push it into double digits in early 2022. Despite these efforts, inflation will grossly overshoot the central bank's target for 2021.

The liberalization of the country's foreign trade regime, combined with a more active policy of trade promotion in recent years, abundant natural resources and strong industrial capacity have stimulated growth in Brazil's trade activity.

Brazil has emerged as an important player in the global merchandise trade market, though exports account for 15% of GDP. The liberalization of the country's foreign trade regime, combined with a more active policy of trade promotion in recent years, abundant natural resources and strong industrial capacity have stimulated growth in Brazil's trade activity.

The contraction in the third quarter was driven primarily by an 8% drop in agriculture, which has been affected by an unprecedented drought, and a 9.8% decline in the exports of goods and services. Industry remained stagnant, while services grew 1.1%. Latin America's largest economy had rebounded quickly from the initial impact of Covid-19, with GDP in the first quarter of this year returning to where it was before the pandemic struck at the end of 2019. However, since then the recovery has lost steam and some economists are forecasting a contraction in 2022. Presidential elections in October 2022 also threaten to bring uncertainty. The government was hit by the recent resignations of top officials in the economy ministry, amid mounting concerns that the president will likely circumvent fiscal rules in order to

boost welfare payments ahead of next year's elections.

Meanwhile, the Brazilian Finance Minister has remained bullish, predicting a V-shaped recovery, and GDP growth of 5% in 2021 (and more than 2% in 2022). This compares with forecasts by leading Brazilian banks which predict 2021 GDP growth of 4.8% and a slight contraction of 0.5% next year.

President Jair Bolsonaro and a high level diplomatic delegation have completed an official tour of Middle Eastern countries. Mr. Bolsonaro is on a diplomatic push to revive his international image and find new trade and investment allies. At the same time, Mr. Bolsonaro's likely opponent in upcoming October 2022 elections, Luis Lula da Silva, was visiting Germany, Belgium, France, and Spain with a message of more international cooperation and engagement – a move that could win support from Brazil's political center.

Lula, the left-wing former president (2003-10) was given a presidential reception in France and a standing ovation by the European parliament. President Bolsonaro's foreign-policy standing has diminished in Europe by concerns over his government's poor environmental track record and his increasing estrangement from the U.S. since the Biden presidency. Lula's message is that he would end the country's political isolation. Lula also used his visit to broaden his appeal to Brazil's business community: his stress on the importance of ratification of the EU-Mercosur free-trade agreement highlights perceived weaknesses in President Bolsonaro's leadership on the international stage. Still, there is a long way to go before next year's election. Many expect Bolsonaro to abandon fiscal rectitude and hand out cash to Brazil's poorest in order to win votes. Lula's economic policies are unclear, although he has spoken out against privatization of state companies and a government spending cap, which is considered a key fiscal anchor. It appears that both candidates are viewed warily by the Brazilian business community.

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In theory, Brazil continues to present notable opportunities to foreign investors. The country has a large domestic market, is rich in natural resources (particularly agricultural and mining commodities), is well positioned geographically to serve as a base for a company's Latin American operations; and houses a recently enlarged middle class that has boosted domestic demand and created new business possibilities. In practice however, the country's recent recession, ongoing political turmoil, and poor handling of the Covid 19 pandemic have reduced its appeal as a foreign investment destination.

Foreign direct investment (FDI) to Brazil fell from \$67.6 billion in 2019 to \$44.7 billion in 2020, reflecting the negative impact of the pandemic on foreign investment activity. However, the country remained the ninth largest recipient of foreign capital inflows in the world and the largest in Latin America. The forecast is for FDI to recover gradually over the next five years. According to the central bank, the U.S. was the largest source of FDI to Brazil in 2020, accounting for 23% of total inflows. It was followed by the Netherlands, France, and Spain. Oil and gas extraction attracted around 12% of FDI inflows in 2020, followed by commerce (9%), motor vehicles and parts (8%), and non-financial holdings (6%).

Zambia

The country has agreed to the terms of a \$1.4 billion bailout with the IMF, a crucial step towards ending the debt crisis in the copper-rich but near bankrupt nation. The deal has been several years in the making and is a step forward for Zambia – which last year became the first African country to default since the start of the pandemic.

The three-year extended credit facility, which has been in the making for some time, is a landmark

achievement for the four-month old government of President Hichilema's – after unseating Edward Lungu who dragged out talks with the IMF even as Zambia's debts spiraled.

Zambia is Africa's second largest copper producer and is struggling under \$15 billion of external debt, including arrears, after a spending spree gave way to an economic slowdown under former President Lungu. The new President Hichilema has declared that he inherited a completely empty treasury and says he needed the IMF deal to convince Chinese and private creditors to restructure their debts; as well as positioning the country to secure other financial support from bilateral lenders.

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Last year Zambia stopped payments on \$3 billion of Eurobonds and negotiated debt reprieves with Chinese lenders. The agreement with the IMF is based on the authorities plans to undertake bold and ambitious economic reforms. The Finance Ministry is intent on using the IMF program to provide needed fiscal space and to anchor the government's domestic economic program. The government will face difficult compromises in order to comply with the IMF conditions. For example, it has pledged to cut Zambia's fiscal deficit to 6.7% of GDP in 2022, down from 10% in 2021, and then to aim for surpluses. The government has promised to protect health and education programs and to devolve much more spending to local government. A revival in global copper prices this year [to ten-year highs] has cushioned state revenues. This is expected to last over 2022.

President Hichilema has rehired a central bank governor whose abrupt dismissal by the former president last year drew the IMF's ire and he has launched ambitious plans to revive foreign investment in Zambia's copper mines. The government is targeting GDP growth of 3.5% in 2021 and 3% in 2022, following a

contraction of approximately 3% in 2020.

Even with the IMF support, the government will have a tough task balancing competing interests of Zambia's creditors - in talks which they aim to conclude early in the new year. The finance ministry has revealed that the share of Zambia's debt owed to China is \$6 billion, or double what was previously reported. That raised concerns that there could be more hidden debt and risks complicating negotiations with creditors. Bondholders have expressed fears that any money they gave up will be used to pay-off Chinese creditors. The government has pledged equal treatment to all creditors. Zambia has already received \$1.3 billion of funds from the IMF in 2021 under the global allocation of special drawing rights to member countries.

There are reports that billions of dollars had been stolen through extravagant spending and kickbacks on construction projects, as well as corrupt fuel and fertilizer subsidy schemes under the previous government. The new government sought to recover stolen assets and clamp down on procurement practices that had in the past vastly inflated prices from roadworks to stationary supplies. Private creditors have sought transparency on debt before renegotiating payments.

Cash is tight after the previous government spent heavily on subsidies in the run-up to August's election, increasing the fiscal deficit above 10% of GDP. The new government is resisting calls for a windfall tax on mining. An ambitious target of nearly quadrupling annual copper production from the current 880,000 tons depended on reassuring investors that Zambia provided both an attractive and dependable business environment. Nonetheless, the government is under pressure to extract more revenue from the sector and to open it up to greater opportunities for Zambians. Local economists stress that the government should emphasize to mining groups that they need to contribute much more to the economy, especially with the price of copper at current highs.

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With the companies making windfall profits, it would only be fair for Zambia to benefit, they argue.

Turkey

The Turkish lira plunged further in value triggering the resignation of the country's finance minister. Since September the lira has lost 40% of its value while President Erdogan maintains his fierce opposition to high interest rates. While the lira's value falls, Erdogan pressed the central bank to lower the benchmark interest rates to 15% despite annual inflation of 20.7%.

That approach has prompted warnings from economists that the Turkish government is running the risk of spiking runaway inflation and financial instability. The political interference in the central bank's interest rate policy and the drift away from pursuing orthodox policies has prompted the country's finance minister Lutfi Elvan to resign. Regarded as the last remaining voice of economic orthodoxy in the cabinet, Elvan was replaced by an Erdogan loyalist. The new finance minister has offered a full public defense of President Erdogan's policy of cutting interest rates despite rising inflation.

The outgoing finance minister was highly respected by the business community, but the technocrat had become increasingly isolated in recent months. He had publicly insisted that the Turkish government was still seeking to bring inflation down and maintain a stable currency, even though the central bank had cut its benchmark interest rate for the third month running in November. Elvan's resignation came after Turkey's central bank announced a return to a controversial policy of intervening in currency markets in an attempt to steady the tumbling lira, despite limited



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foreign exchange reserves. The central bank revealed that “unhealthy price formations” had prompted the decision to sell hard currency, including U.S. dollars, in an effort to support the falling lira.

Turkey had not announced a direct currency intervention since it sold \$3.2 billion in early 2014. However, the country burnt through tens of billions of dollars of its foreign currency reserves in 2019 and 2020 in an unofficial and ultimately unsuccessful attempt to prop up the lira - which drew strong criticism from the political opposition.

Analysts now warn that Turkey could be headed towards hyperinflation. The country is heavily reliant on imports, crude and other raw materials that have become increasingly expensive as the lira slides. According to leading private Turkish banks, headline consumer price inflation will likely hit 30% over the coming months. In the past, the Turkish president delegated economic policy to ministers, the central bank and institutions. Today, the control of Turkey’s \$795 billion economy is now in the hands of one person, President Erdogan. The president’s economic policy going forward will prioritize investments and exports driven by low interest rates – with no regard for price stability. That will be pursued despite the weakened lira. The result is likely to be a reversal in the recent improvement of the country’s foreign currency reserves.

One speculation is that the new finance minister will attempt to use state-owned banks as a tool to try and soften the impact of rapidly rising inflation and falling living standards by ramping up cheap lending to households and businesses. It has also been suggested that the administration would use state-owned banks’ balance sheets to defend the lira and the country’s aggressive credit growth. For that to work, the Erdogan administration would first have to inject fresh capital into the banks, many of which are suffering from weak profitability.

Inflation is set to accelerate further in the months ahead. The latest collapse in the value of the lira has

yet to be reflected in many prices. Moreover, recent price hikes for bread and other household goods are only partly reflected in the November figures. The price of natural gas for use in power generation and industry has been increased by a further 20% for December. In January, indirect taxes and fees for public services are due to rise by up to 36.2%, although the government may set a lower increase.

Strong export demand and resilient domestic demand have sustained Turkish industrial capacity in 2021. Unadjusted figures show that capacity utilization fell to 72.7% from 76% in October and 80.3% in September, probably reflecting the impact of shortages of digital components, which may be temporary.

These figures suggest that the economy has continued to register substantial year-on-year GDP growth in the second half of 2021. Turkish central bank figures also show that confidence in the manufacturing sector remained fairly optimistic about existing orders and likely export orders. The 2021 GDP growth estimates were revised to 10% (up from 8%). In 2022-23 slower demand and potentially unstable conditions are likely to temper growth in industry and the economy in general. GDP growth in 2022 is projected at 3.3% and for 2023 the estimate is 3%.

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