Major Country Developments April 2016

By Byron Shoulton

Overview

The U.S. Federal Reserve has reiterated the need to proceed cautiously in raising interest rates given unfavorable market conditions, weaker overseas growth and an uncertain inflation outlook. The rate of U.S. job growth in March remained robust and wage gains inched forward. A slight rise in the jobless rate (from 4.9% to 5%) resulted from a greater number of job seekers entering the market. The economy added 215,000 jobs in March, down from 245,000 the previous month. This gives credence to the Fed's caution on the economy. The Fed warned of the potential for the weak global environment to begin weighing on the U.S. labor market, even if not yet evident in the data. Still, 5% unemployment is an important improvement from the crisis-era peak of 10% in October 2009. Even as slack in the U.S. labor market has tightened, several measures have remained subdued. Most watched has been wage growth, which has remained fairly tepid-which in theory should put upward pressure on wages. Slow growth and low energy prices have weighed heavily on inflation abroad. While the Fed does not want inflation to pick up too much, excessively low inflation could weigh on economic growth by cooling consumer spending.

Gold prices saw their largest quarterly gain in three decades, showing that worries about the markets and economy continue despite a recent rally in stocks, bonds and commodities. Gold prices rose 16.5% in the first three months of 2016, the biggest leap since 1986. Meanwhile, oil prices slid at month-end after Saudi Arabia cast doubt on participating in a deal among leading oil producers to freeze output, saying it would only consider taking part if Iran also complied. Tehran has repeatedly said it will not restrain its production as it recovers from years of sanctions against its oil industry. Saudi Arabia took steps to slow Iran's efforts at increasing its oil exports, banning vessels that transport Iranian crude from entering Saudi waters, according to traders and shipbrokers.

Iran already faces insurance, financing and legal obstacles despite the lifting in January of sanctions linked to its oil industry. Since then, Iran has managed to sell only small volumes of crude to Europe, including barrels to Spain's Cepsa, Total of France and Russia's Litasco. Iranian vessels carrying the country's crude are restricted from entering ports in Saudi Arabia and Bahrain. Ships that have called to Iran as one of its last three ports of entry will require approval from the Saudi and Bahraini authorities before entering their waters. Also, Iran is yet to regain access to storage tanks at a key oil transit hub on Egypt's Mediterranean coast, which is part-owned by Saudi Arabia.

Argentina finally settled with so-called holdout investors from its 2001 sovereign debt default. The holdouts will receive about half of the total agreement-$2.28 billion for an investment of about $177 million. This represents a total return of 1,180 percent. The resolution has some negative implications for the international financial system, encouraging other funds/creditors to resist compromise, thus making future debt restructurings more difficult. Most indebted countries are intimidated by hostile creditors and accept what is demanded, with often devastating consequences. According to independent estimates, 52% of sovereign restructurings with private creditors since 1980 have been followed by another restructuring or default within five years. Greece, the most recent example, restructured its debt in 2012, and only a few years later it is in desperate need of more debt relief.

In Brazil, the main coalition partner to the beleaguered government voted to withdraw its support, abandoning President Dilma Rousseff and the ruling Workers Party (PT). The move by the Brazilian Democratic Party (PMDB), a loose federation of regional politicians, has increased the odds that Ms. Rousseff could be impeached. Her vice

president, Michel Temer, a 75 year-old constitutional lawyer who is also head of the PMDB, would take over as acting president if two-thirds of the lower house of congress votes for impeachment. Mr. Temer is said to be assembling a market-friendly economic team to try to pull Brazil out of its economic malaise. But any new government will face serious challenges in quickly reversing Brazil's deep budget deficit during a recession.

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The political crisis comes as Brazil struggles to deal with its worst recession in recent memory and a widening corruption investigation at state-run oil company Petrobras that has engulfed the government and damaged the reputation of leading Brazilian companies. The impeachment case against Ms. Rousseff rests on allegations that the president improperly manipulated the fiscal accounts to boost her electoral chances in 2014, thereby breaking Brazil's fiscal responsibility laws. However, the vote will be driven by political considerations -i.e. whether legislators want to remove an unpopular president- rather than the merits of the case. The government has painted the move to unseat the president as a coup and is rallying its militant supporters in Brazil's trade unions, as well as organizations for the landless rural and urban poor, among others. This is leading to concerns that there could be street confrontations between pro and anti-Rousseff supporters should the impeachment vote go through. Uncertainty over Brazil's outlook will persist for some time.

Canada

The manufacturing sector showed renewed vigor in January as sales rose by 2.3% to reach a record $40 billion. Vehicles and parts, and food products were the categories that posted the largest gains. This provides evidence that the weakening of the Canadian dollar, allied to continued demand from the U.S. (which remains Canada's largest export market) is supporting the economy. The energy sector remains under extreme pressure causing the economy to post GDP growth of 1.2% in 2015, the weakest pace since 2009. That was due to weaker oil exports during the first six months of the year when the economy was in recession. It experienced only modest recovery during the second half. Due to investment pullback in energy, overall business investment fell by 3.6% for the year. Private consumption rose by a modest 1.9%, and government spending grew by 1.4% while exports expanded by just 0.1%.

The expectation is that 2016 will show marginal economic improvement over 2015 with GDP growth projected at 1.6%. Private consumption is expected to remain mediocre, at below 2%, as consumers have already pushed their indebtedness to record levels. With consumers financially stretched, and bubble-like conditions forming in some housing markets, Canadian households will not be able to take on much new debt, even though borrowing costs will remain cheap. Indebted households and the potential for a fall in house prices are the biggest risks to the financial system. Business investment is expected to contract this year as the price of oil remains low. The non-oil export sector is performing better owing to the greater competiveness provided by the weaker Canadian dollar. Another encouraging sign for demand in the economy is a falling inventory-to-sales ratio. This implies that firms will continue to restock, which should contribute positively to economic growth.

Having cut interest rates twice in 2015, Canada's central bank is expected to keep its policy rate on hold throughout 2016, with a view to beginning a tightening cycle in 2017. At the central bank's March meeting it noted the improvement in non-oil exports but stated that risks to the economy remained balanced. Consumers and businesses will benefit from low global oil prices, which will reduce transport and heating costs, leaving them with more disposable income. Consumer price inflation rose to 2% in January. This was the first month in which fuel prices were higher on a year-on-year basis since October 2014 and the third consecutive month in which inflation has accelerated. Over this period the inflation rate has doubled, from 1% in October 2015 to 2% in

January. The main cause for the uptick has not been domestic demand but the weakness of the Canadian dollar. The currency weakened by 13% since June 2015, falling from C$1.25: US$1 to C$1.41: US$1 at the end of January. This has generated imported inflation in a host of foreign goods.

The unemployment rate inched up to 7.2% from 7.1% as the economy continued to face the negative impact of low commodity prices. The brunt is being felt in Alberta, where the unemployment rate is 7.4% (higher than the national rate for the first time since 1988). Jobs in the energy sector are concentrated in Alberta, Saskatchewan and Newfoundland. Alberta, which accounts for more than three-quarters of oil production and two-thirds of natural gas, has been hardest hit. However, Alberta is not the only province that is suffering from the weakening of the energy sector. Ontario was the only province to record recent employment growth. Firms supplying energy-related services are receiving less business as companies continue to scale back planned investments. Investment in the oil sands is projected to be about $29.5 billion in 2016, around 50% less than in 2014.

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Canada's ruling Liberal Party which came to power in late 2015 (in a close three-way election race) has pledged to run narrow deficits of around $8 billion a year, to fund a raft of infrastructure projects to repair the country's creaking transport systems. Federal spending is projected to rise from 13.6% of GDP to 14.6% this year. The fiscal outlook has deteriorated since the election, owing in part to a renewed fall in the price of oil, which has hit the government balance by reducing corporate tax revenue. A recent report by the central bank suggested that the new government's spending pledges and the effects of weaker revenue could result in the federal budget deficit ballooning to C$490 billion. The Prime Minister acknowledged that based on current growth projections a return to surplus by 2019 would be difficult. Private sector forecasters expect the government budget deficit to narrow during 2017-18 as oil prices gradually rises. A renewed widening of the deficit in 2018-19 is expected when the economy slows in line with another soft period in global activity. Confidence in the economy is at its lowest point in 20 years, according to a recent poll.

Canada and the European Union (EU) are inching toward finally signing a trade agreement. They both reached agreement in principle back in 2013 and released the final text a year later, but since then the accord has been in limbo. The trade agreement would remove over 99% of the tariffs between Canada and the EU, and overall will make it easier for Canadian companies to do business across the Atlantic. The main stumbling block on the road to completion and ratification of the agreement has been the section dealing with investor disputes, which allow investors to request international arbitration when they feel that their rights have been violated by states.

U.K.

While the U.K.'s trade and commercial environment improved over 2015, the authorities cannot ignore the weakening of global growth prospects – particularly the continued weakness in global trade. Currently, domestic consumption is driving the U.K. recovery and the Bank of England sees little reason to expect domestic consumption to fall at this point. On balance, the central bank can be expected to eventually raise rates as recession worries recede and if sentiment in emerging market economies starts to stabilize. However, much will depend on domestic wage pressures, which look somewhat weaker today than they did six months ago. High levels of U.K. household debt- much of it borrowed on adjustable or semi-adjustable mortgages-underscores that any rate increase will be gradual and modest relative to past rate hiking cycles.

Despite relatively sound economic growth in recent years, payment performance in the U.K. remains still somewhat sluggish (prompt payments now average 21.7% down from 27.3% in 2014). Best prompt payment experiences were noted in construction, agriculture,

manufacturing and retail. Payment patterns vary in different regions of the country. Recent data also revealed that insolvencies fell by 18.2% in 2015 and this is likely to continue throughout the next 18 months, positively impacting credit risks.

Eurozone exports to the U.K. would suffer a shock if, as foreign exchange markets expect, the pound fell sharply after a vote to exit. Another concern relates to European companies that use their U.K. operations to sell to the world.

On June 23 this year, the U.K. will hold a referendum on whether to remain in the European Union or leave (the so-called "Brexit"). The question to be settled is whether the EU is right for Britain. For the rest of the world, a larger question is what impact a British exit would have on the EU. Precise calculations are impossible, but Brexit would in all likelihood harm the EU economy. Political damage would be significant and the effects would probably be destabilizing to continental Europe.

About two million jobs in the 19-nation eurozone depend on trade with Britain. Eurozone exports to the U.K. would suffer a shock if, as foreign exchange markets expect, the pound fell sharply after a vote to exit. Another concern relates to European companies that use their U.K. operations to sell to the world. They would face stiff tariff barriers in non-European markets if, post-exit, Britain failed to keep its EU-based free trade accords with the rest of the world. The consensus is that Brexit would plunge trade and investment between the British and their European neighbors into uncertainty, especially if attempts to work out a new relationship turned nasty.

With Britain out of the EU, Germany, France and other contributors to the 28-nation bloc's budget would have to make even bigger payments than they do today. Ideally, a new British-EU trade regime would be completely free of tariff and non-tariff barriers damaging to businesses on both sides. However, political frictions could put those goals beyond reach. During its lengthy involvement with the EU and its forerunner, the European Economic Community, Britain has been a consistent voice for liberal economic policies. It was a driving force behind the EU's single market, established in 1993, and is a strong supporter of extending it in the services sector. Removal of the British and the EU's internal balance could tilt toward a more protectionist camp represented by France and like-minded nations. Britain's absence from the EU would probably not help the prospects for a far-reaching EU-U.S. free trade deal.

As France is preoccupied with domestic terrorism, economic stagnation and populism, Brexit would tend to reinforce Germany's political and economic pre-eminence in the EU. Despite disappointment over halfhearted British attitudes toward European integration, Germany -like the Netherlands, Sweden and others- prefers the EU with the political balance provided by Britain. A Brexit would demonstrate for the first time in the post-war era that EU integration can go into reverse as well as forward. It would boost anti-establishment, anti-EU forces across the continent. In some places, nationalist pressures would build for concessions. According to one poll, 53% of French voters want a referendum on EU membership.

Also, by reigniting demands for independence in Scotland, where a majority would probably be keen to stay in the EU if an English majority voted to take Britain out, an exit would fan the flames of separatism in other states, first and foremost Catalonia in Spain. It would also risk destabilizing the peace that has prevailed in Northern Ireland since 1998 by throwing up barriers between British-ruled north and the Republic and revive the radical nationalist project of Irish unification. All these dangers would likely remerge when the EU already has its hands full with the refugee crisis, weak economic growth, high unemployment, the problem of Greece's eurozone membership and tensions in EU-Russian relations.

For Britain, today's tension-filled international climate demonstrates that its national interest is tied to peace, prosperity, democracy and stability in continental Europe. It follows that, if Brexit is a bad idea in Europe, it is probably a bad idea for Britain.

Pakistan

A deadly terrorist incident in late March killed 72 people and injured hundreds in Lahore, capital of Punjab province, Pakistan's political heartland. This confirms that extremists retain the intent and capacity to strike the country despite an aggressive counter-terrorism campaign since mid-2014 which disrupted insurgent operations in various tribal-area strongholds. The targeting of Punjab, which is the political base of Prime Minister Nawaz Sharif, exposes serious gaps in a national action plan against terrorism initiated in 2014.

Economic growth remains below potential as a volatile security situation plus water and electricity shortages continue to weigh on economic activity. Moreover, low investment in human capital and the existence of barriers preventing women from fully participating productively in the workforce make it unlikely that Pakistan will experience a quick economic turnaround. Supported by Chinese investment under the China-Pakistan Economic Corridor (CPEC), the expectation is for GDP to grow on average 4.8% over 2016-2020. This suggests that Pakistan will lag behind its South Asian neighbors over the period.

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The trade deficit is projected to widen over the period as a result of greater demand for imported investment and consumer goods. As a percentage of GDP, the current account deficit decreased from 1.1% in the preceding fiscal year to 0.9% in July-February. Pakistan's total imports of goods in July-February were valued at $26.3 billion as opposed to $27.9 billion in the same eight months of the preceding fiscal year, which shows an annual decrease of 5.7%. Declining oil prices will result in a year-on-year fall of over 23% in the oil import bill in 2016, according to the IMF. However, should oil prices recover after 2016 the import bill will increase again.

Pakistan exported goods worth over $14.4 billion in July-February compared to exports of goods valued at $16 billion in the same period last year, reflecting an annual decline of 9.9%. Not only are exports declining, but the rate of decline is higher than the corresponding decrease in imports. Going forward, exports will be supported by steady gains in global trade growth and stronger commercial links with the EU. However, exporters in Pakistan will struggle to take full advantage of these opportunities owing to persistent power shortages and poor basic infrastructure. Meanwhile, rising worker remittances contributed to a steady improvement in the external sector, accounting for almost half of the import bill and covering the deficit in the trade account. Remittances were $12.7 billion during July-February, up 6% from the similar period the previous year. This trend is expected to continue over 2016-17.

The government has placed reform of the power sector as a top priority, with several state-owned enterprises earmarked for overhaul. Obsolete infrastructure for the generation and distribution of electricity has been unaddressed over an extended period. Government price controls have damaged the ability of power companies to be profitable and to undertake upgrades. This will have to change at a fast pace if Pakistan is to attract investment, create jobs and modernize.

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FCIA's Deals Of the Month

Bank Policy: Receivable purchase, $12,000,000 limit of liability, apparel industry, USA

Multibuyer Non-Cancelable Limits Policy: Covering $45,000,000 in export sales in the Agri sector for risk mitigation, South America

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