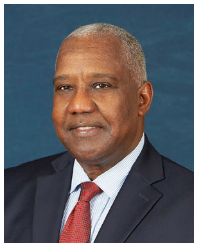
Major Country Developments
November 2018



By Byron Shoulton

Overview

Stock markets around the world tumbled in October pointing to falling sentiment regarding future corporate earnings, weaker trade flows and heightened geopolitical tensions, which many fear will contribute to a slowing global economy. Major stock indexes registered their biggest one-month loss in several years, hurt by growing worries about the health of the global economy, as well as broader concerns about tightening monetary policy. Sustained selling in technology stocks, which had accounted for much of the broader market gains earlier this year, added to investors' anxiety. Economic data suggests that there was a decline in global activity during October. The global growth rate seem to have peaked late in 2017, and since then there has been a noticeable slower average pace of activity. The period of above-trend growth that was so powerful last year proved short-lived. Growth in the world economy slowed from a peak of 5% a year ago to 3% currently. Much of this decline has occurred in the last couple of months.

Mounting tensions between the **U.S.** and **China** contributed to declines in stock values. Dramatic moves toward a trade war exacerbated a fall in confidence. At the same time, the U.S. moved to restrict U.S. firms from doing business with a leading Chinese state-owned microchip maker. Following complaints that the Chinese firm had stolen secrets from a leading U.S. manufacturer of microchips, the Administration, citing national and economic security concerns, have restricted U.S. companies from selling software to the Chinese entity. This approach could spread if China fails to respond to calls to curb often unlawful and aggressive acquisition of foreign technology. The U.S.-China stand-off worsened with the U.S. threat to hold up further trade talks unless China declares what concessions it is prepared to make ahead of the talks. The talks were meant to set the stage for comprehensive discussions between the leaders of both countries slated for an upcoming summit in November. Both sides have important incentives to cut a deal.

Concerns about the future health of the global economy have sent not just stocks but also bonds and commodities on wild swings in recent weeks. **China,** which faces its own economic slowdown [GDP growth slowed from 7.4% last year to 5.3% currently], must act if it is to head-off U.S. imposition of a further 25% tariff on the remaining $200 billion of Chinese exports to the U.S. that have not, so far, been subject to tariffs. A slowing Chinese economy means the likely reduction in demand for various raw materials, minerals and commodities - as China is the largest importer of certain raw materials [many of which it already holds large stockpiles of - e.g. copper, iron ore, aluminum, crude oil, soy].

The Chinese currency, the yuan was guided to its weakest official level in a decade – a move that could fuel expectations of a further, self-enforcing slide. The central bank set the dollar's reference rate at 6.9:$1. The currency has been hit this year by China's economic slowdown and could be hit even harder by additional U.S. tariffs on hundreds of billions of dollars of Chinese goods. As the yuan gets close to the symbolic seven-per-dollar level, currency traders expect the Chinese central bank to put up a fight to prevent the currency from weakening further. The trade war with the U.S. plus a strong dollar have increased pressure on Chinese policymakers to find ways to bolster growth. The central bank pumped $108 billion into the economy by reducing the amount of cash banks have to hold as reserves, after figures showed that both investment and exports have weakened. The Chinese politburo has admitted that the economy is being affected by external forces.

The Chinese now appear prepared to act aggressively to boost private sector activity.

USA

The U.S. economy posted one of its best six-month performances of the past decade with GDP growth of 3.5% during June – September 2018. This was a faster pace of growth than previously projected. The economy added 250,000 new jobs in October and the unemployment rate remained at 3.7%, the lowest level in 49 years. Wages grew at the strongest pace in a decade (3.1%). However, signs appear to be gathering that future growth will not be as strong, given a consensus of forecasts anticipating slower growth over the coming quarters.

Many now believe that U.S. growth has peaked. The reason: two big drivers of growth this year – consumers and government spending- are likely to slow in the months ahead: Consumers because the impetus from income-tax cuts will diminish; and government when the deal to boost spending runs out next September. The U.S. government's projection of sustained GDP growth of 3% hinges on a business-investment boom. That appeared to be true early in 2018 but has faded since, suggesting that corporate tax cuts may not have the long-lasting impact that was intended. Losses to stock portfolios and 401(K) accounts due to recent market correction, will tend to dampen consumers' confidence and hence their willingness to continue spending at levels seen over the past year. GDP growth for 2019 is projected at 2.2%. U.S. fiscal and monetary policy will be far less supportive next year than they were in 2018. Furthermore, financial conditions will be much less accommodative, in response to Fed tightening.

Meanwhile, U.S. companies are raising prices on a variety of services and products, passing on higher costs for fuel, metals and food to customers after years of low inflation. Manufacturers, airlines, food makers among others, all announced price hikes in late October. The price increases effectively ends a long period of low inflation that led the Federal Reserve to keep short-term interest rates near zero for years. This is a tricky moment for the U.S. economy. Unemployment is at its lowest point in almost five decades, and economic growth is still strong. Inflation is now at the Fed's 2% target while prices climb higher and effects from tariffs intensify. U.S. tariffs are likely to remain in place and may even escalate. Counter tariffs imposed by trading partners in response to U.S. moves, will also remain until new trade agreements are reached with the U.S. and tensions ease. Conversely, other factors could help offset those pressures, including the strong dollar, which makes U.S. imports cheaper and competition for market share intensifies. Some companies are raising prices to help cover rising ingredient and transportation costs. Airlines are paying 40% more for fuel than a year ago. Trucking costs are up 7% annually, and U.S. manufacturers are paying 8% more for aluminum and 38% more for steel than a year ago as the industry adjusts to tariffs levied on imports of those metals. A 10% tariff imposed in September on $200 billion worth of Chinese imports is also weighing on businesses that buy and sell those goods. Consumer products such as shoes, handbags, clothing, etc., face price increases with the potential of pushing inflation higher in the year ahead.

Mirroring concerns of a possible slowdown amidst a changing credit environment, two leading U.S. credit card issuers tightened lending standards [an unusual move in a strong economy]. This may signal longer-term doubts about consumers' financial health. Financial institutions also are tightening lending guidelines, amidst hints of a possible overheating that could spike non-performing loan ratios. There are growing anxieties as to how long U.S. economic gains can continue, given rising interest rates, high tariffs against imports and mounting uncertainty caused by trade and geopolitical tensions. The Federal Reserve appears set to maintain its plan to keep raising short-term interest rates by modest increments over 2019.

Separately, U.S. farmers in 2018 planted more soybeans than corn for the first time in three decades, betting on strong demand in China, typically the largest foreign buyer of the crop. However, soybean for export from U.S. ports bound for China – recently stood 82% below their year-ago level. This as a result of Chinese retaliation against U.S. tariffs on Chinese exports to the U.S. American grown soy prices fell by 11% this year. The U.S. farm belt is preparing to reshape the sector by planting more corn and less soybean next year. China imports around 100 million metric tons of soybean per year, about half of which comes from **Brazil** and a third from the U.S. With Beijing keen to punish Washington, the question for American farmers is how quickly China can reduce its dependence on U.S. soybeans. U.S. companies are tempering the effects of escalating tariffs with China through price increases or changes to their supply chains, while they expect the picture could worsen in 2019.

U.S.-Russia tensions seem to rise and appear to threaten existing curbs on nuclear arms - intended to prevent war between both countries. NATO officials revealed that Russia has developed a new missile system with the capability of carrying nuclear warheads and whose potential range breaks the existing treaty. The U.S. argues that Russia has contravened the arms control treaty for years and is struggling to find ways to bring Moscow back into compliance. Each side has accused the other of violating the Intermediate-Range Nuclear Forces (INF) Treaty, an agreement signed by the U.S. and the Soviet Union in 1987 which banned land-fired missiles with a range of up to 5,500 kilometers. The breakdown in the relationship appears to pose a threat to progress aimed at maintaining nuclear deterrence. The Russians suggest that the U.S. side is not interested in meeting to find ways to tamp down distrust between both countries. However, U.S. officials insist that they are fully committed to continuing to uphold U.S. arms control obligations and stress that they expect Russia to do the same.

Meanwhile, there are no indications that U.S. sanctions imposed against Russia will be lifted any time soon.

Brazil elected a firebrand ex-army captain as its next president, joining the growing ranks of anti-establishment leaders across the world and shifting Latin America's largest nation sharply to the right. Jair Bolsonaro, a champion of Brazil's 1964-1985 right-wing military dictatorship that he once served, has promised to unite Brazilians, reform public finances and negotiate more trade deals with developed countries. Brazilians desperate for an end to an historic recession, endemic political corruption, and rising street crime, have endorsed drastic measures advocated by President-elect Bolsonaro.

Even with limited leadership experience and no consensus with other political parties, Mr. Bolsonaro enjoys broad support across the private sector and among the broad populace. He might be challenged to forge alliances with other parties in congress in order to pass important legislation. Either way, Brazilians are very anxious for a turnaround in economic growth [not seen since 2012]; a reduction in unemployment (currently above 12%) and ending endemic corruption. GDP growth is projected at a meagre 1.2% in 2018 and the fiscal deficit hovers at around 8% of GDP. The new president will take office in January and has promised close ties with the U.S. He has appointed the country's leading prosecutor [who has had great success in the Car Wash scandal] as his justice minister. While calling for more free-trade agreements, Mr. Bolsonaro is expected to also address large inflows of inexpensive Chinese imports over decades, which seriously weakened Brazil's manufacturing sector. Local producers have been unable to compete with Chinese imports, hurting job creation, profitability and contributing to the recession. The built-up pressure to reignite economic growth cannot be underestimated.

Eurozone

The Eurozone reported disappointing data throughout 2018. The region's economic slowdown steepened in October as activity was held back by German delays in testing automobiles for compliance with new emissions standards and weakening demand for the currency area's exports. October's dip has taken GDP growth down to 1.1% for the year. However, the easing of economic growth isn't yet severe enough to disrupt the European Central Bank's plans to end its bond-buying program in December. If the downturn is sustained, it may delay a first rise in the central bank's key interest rate, which is expected toward the end of 2019.

The Eurozone Purchasing Managers' Index fell to 54.3 in October from 57.1 in September. A reading above 50.0 signals an expansion in activity. The survey recorded a pick-up in activity in France, the second largest Eurozone economy. This was offset by the weakest performance in 41 months for Germany, the area's industrial powerhouse. German manufacturers are seeing slowing overseas demand, with export orders falling for the second consecutive month. Across the Eurozone as a whole, new orders placed with manufacturers by foreign buyers fell for the first time since June 2013. Weak demand for Eurozone exports from slowing developing economies is likely to prove a more persistent drag on growth, while households face higher energy bills that will likely cut into spending on other goods and services.

Meanwhile, Germany's Chancellor Angela Merkel decided not to seek re-election as chair of the Conservative Democratic Union (CDU) after 18 years at the helm. Ms. Merkel will not run for the post of Chancellor in 2021. The move comes after her party's poor showing in the state of Hesse, home to Germany's financial industry; as well as a series of nationwide polls that placed Germany's traditional political parties at historic lows versus right-leaning nationalists' parties. The message is clear in Germany and elsewhere in the Eurozone: nationalism is on the rise with serious implications for maintaining cohesiveness within an already split currency union.

Brexit negotiations have become deadlocked, with questions over how to deal with the border between Northern Ireland and the Irish Republic becoming a tough sticking point to overcome. Standard & Poor's Global confirmed that the chances of a no-deal Brexit have increased and warned that such an outcome would spark a long recession and a likely drop in Britain's credit rating. S&P still believes it's possible that the UK and EU can strike a deal in which the transition period runs through 2020, followed by a free trade agreement. However, the risk of the UK crashing out of the block without a trade agreement has increased substantially. This reflects the inability thus far of both sides to reach an agreement on the Northern Irish border issue, the critical outstanding component of the proposed Withdrawal Treaty. The British Prime Minister also faces a significant hurdle in selling any eventual agreement to parliament – with factions in her own Conservative Party split on how to proceed.

Meanwhile, European companies could be forced to move financial instruments worth billions of dollars as Britain prepares to leave the EU. The process, known as repapering, might be required for syndicated loans, currency swaps and other derivatives taken out by EU-based corporates and booked through banks in the UK.

Depending on the course of the Brexit negotiations, regulations that currently cover the City of London, the heart of the UK's and Europe's financial industry, may stop applying as early as March 2019. That could make it necessary to relocate thousands of financial products used by corporates to an EU-based financial entity. Company executives, mired in uncertainty about the final outcome of the Brexit negotiations, will likely face significant paperwork and additional costs.

Saudi Arabia's credibility and that of its new leadership suffered a major blow after **Turkey** revealed complicity by Saudi officials in the disappearance of a Saudi journalist and government critic at the Saudi consulate in Istanbul. This episode could result in the deterioration of Saudi Arabia's relationship with western governments (including the U.S.). Turkey has been determined to air the facts of this case to the world – forcing the Saudi government to change their explanations several times for the journalist's disappearance from the Saudi Consulate.

Saudi Arabia's influence as OPEC's swing producer has been compromised by America's advance as a major supplier of crude via shale technology. While the U.S. is deferential toward the Saud Royal family based on its large purchases of American arms and aircrafts, other western countries are less inclined to be. For now, the position of Crown Prince Mohammed bin Salman as heir to the throne appears secure. However, two of the prince's closest aides have lost their jobs because they are suspected of involvement in the plot. More of the prince's advisers are expected to be sidelined or fired in due course.

Meanwhile, Turkey released a U.S. pastor who was detained as an enemy of the Turkish state over the past two years. The U.S. imposed sanctions on Turkey earlier this year to force the pastor's release. The sanctions contributed to the decline of the Turkish economy and to the slide of the lira's exchange rate against the dollar. Turkey expects the U.S. to remove at least some of the sanctions in exchange for its conciliatory move.

Separately, German businessmen and politicians have moved to overcome a crisis in relations with Turkey which has developed over the past few years. An 80-member German delegation visited Turkey in October as an important show of solidarity when the country is losing investor confidence and bracing for a painful recession. Germany's economics minister acknowledged that both countries have had difficulties in recent years but Germany is determined to put those concerns behind, in pursuit of better economic relations. Germany and Turkey are NATO allies and have ties that stretch over many decades.

India

The Reserve Bank of India (RBI) is locked in a bitter stand-off with Prime Minister Modi's government – causing one central bank official to warn of "potentially catastrophic" consequences of intensifying government efforts to influence the bank's policies. India's leading business groups are urging the RBI to increase liquidity and ease lending restrictions on fragile state banks to boost economic growth.

Tensions escalated over the government's push to access some of the central bank's reserves to shore up its own finances and step up spending ahead of next year's general elections. Differences over how the RBI's reserves are utilized are the latest indicators of friction between the Modi's administration and the central bank on issues such as banking sector regulation, regulatory attitudes toward non-performing loans, monetary policy and the value of the currency. In a sensitive election year the government is eager to rev up the economy, and has called for higher payouts to the government. It has also urged the RBI to make it easier for financially troubled banks to lend more, despite their bad debt problems. The RBI has been reluctant to comply with the requests to release more of its reserves, or to dilute the tough standards it has developed to clean up the banking sector.

The tensions erupted into public view in October when the central bank deputy governor observed during a lecture that the risks of undermining the central bank's independence can trigger a crisis of confidence in the capital markets. The bank official cited Argentina's example in 2010, when the government passed an emergency decree transferring $6.6 billion from the central bank reserves to the national treasury, overriding the objections of the central bank governor. The Argentine central bank governor resigned, citing the national government's permanent trampling of institutions – and within a month Argentine bond yields rose 2.5 percentage points.

The message from the RBI: governments that do not respect the independence of the central bank will sooner or later reap the wrath of financial markets, ignite economic fire, and live to regret that they undermined an important regulatory institution.

This is an unprecedented blow-up between a sitting Indian government and the central bank. The government installed the current governor at the RBI in 2016 after declining to extend the tenure of his high-profile and outspoken predecessor. His replacement was expected to usher in a "smoother" relationship between both institutions. Instead, tensions between the governor and the finance ministry have escalated following a $2 billion fraud at state-owned Punjab National Bank in February this year. In the aftermath of the bank fraud the finance ministry sought to blame the crisis on the RBI. In response the RBI has declared that it did not have sufficient power to oversee and control state-owned banks compared with its powers over private banks.

The RBI has called for "ownership neutral" regulatory powers. The tussle between the central bank and the Indian government has been long in the making. India's financial industry, especially its public sector banks, has mountains of non-performing loans, rising to 11.6% of total loans - as of March 31, 2018. This unresolved problem has taken a toll on India's investment and growth. The excesses of bank lending a decade ago, which were fueled by government-sanctioned cronyism and irrational exuberance on the part of public sector banks, are unraveling. The credit boom was compounded by the central bank's regulatory failures in not recognizing the magnitude of the problem: non-performing assets tripled between 2014 and 2017. Stung by past failures, the RBI since February 2018 has become tough on loan defaulters, signaling its intent to change the culture of credit in India. Politically connected business leaders, who have long been accustomed to borrowing and defaulting on loans from public sector banks, are now faced with the prospect of either repaying their loans or giving up ownership of their businesses.

The banking sector's non-performing loan ratio is expected to peak in 2019 and should begin to fall in 2020. The share of private-sector banks' total lending should continue to rise over the same period, as most public-sector banks struggle with lingering bad-debt issues. Nonetheless, access to loans remains problematic for many Indian medium-sized companies. India's financial markets were stung further by a recent default: a 30-year-old non-bank financial company (NBFC) – or shadow bank- which has funded some of India's ambitious infrastructure projects, including tunnels, toll roads and sports stadiums. In the past two years, credit from India's shadow banks has expanded by over 20% each year. Overall credit growth, which hit 14% in the first quarter, is now expected to fall as debt market investors – including some of India's biggest business houses – are reducing their exposure to NBFC's.

India is stepping up efforts to win more export-oriented investment in fields such as electronics manufacturing and retail in the years ahead. Trade tensions with the U.S. are expected to rise as both sides adopt an increasingly protectionist stance.

Consumer prices rose by 3.8% year-on-year in September while wholesale prices rose sharply by 5.1%. The continuous rise in energy costs, especially diesel is influencing other costs such as transport. Still, weaker demand is limiting the pass-through from higher input costs to consumers. Merchandise exports fell by 2.2% year-on-year to $28 billion in September, while imports rose by 10.1% to $41.9 billion in the month.

With its swelling middle class, an expanding manufacturing sector and a youthful, increasingly urban population of 1.3 billion, India is primed to overtake China as the top driver of oil demand growth by the mid-2020's. Demand for oil and diesel fuel is rising alongside consumption of modern cooking fuel and electricity and the government has launched policies to boost energy access to support higher levels of economic growth.

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Pakistan

The new Pakistani Prime Minister Imran Khan reversed course and approached the IMF in October, seeking a bailout loan for his country. The previous government lifted annual GDP growth to a ten-year high of more than 5%. However, it did so on the back of expensive imports of fuel and machinery, even while propping up the currency which hurt Pakistani exports industries such as textiles. The result has been dramatic growth in the current-account deficit since 2016.

Foreign exchange reserves have fallen sharply and currently stand at $8 billion, which is not enough to cover the expected import bill and foreign-debt repayments through the end of 2018. To keep the lights on (many Pakistani power plants run on imported coal), the government needs to find around $10 billion in short order.

While the new Prime Minister understood that the country was in need of a bailout loan, he tried hard to avoid going to the IMF. Instead he sought alternatives like asking all Pakistanis living abroad to donate foreign exchange to the government [$1,000 each]; and considered a bailout loan from China and then Saudi Arabia. The Saudis did not offer a bailout, instead they volunteered to invest in the China-Pakistan Economic Corridor (CPEC), a $60 billion infrastructure scheme financed mainly by China. That seemed to upset China, Pakistan's oldest ally, so it was dropped. Some observers thought that China might increase its lending to Pakistan rather than have the IMF pore over the details of the contracts behind CPEC, which had not been made public and are thought to be unfavorable to Pakistan. In the end, the Chinese decided they didn't want to be Pakistan's lender of last resort.

While the Pakistani government searched for benefactors, investors panicked. The stock market had its biggest daily decline in a decade in early October, which spurred the government to turn to the IMF. The delay may have weakened the Pakistanis' negotiations with the Fund over the terms of a loan. In addition to demanding a good look at CPEC contracts to make sure Pakistan can afford them (and that proceeds of an IMF loan wouldn't go toward paying back China), the IMF is now pushing for a further devaluation of the currency, the rupee, increased tax collection and higher interest rates. These will all be highly controversial measures for Pakistanis to accept.

PM Khan assumed power in the summer with a focus on eradicating corruption and creating an "Islamic welfare state". By now, he must have come to the realization that achieving the former will take some time, but the latter will almost certainly have to be reconsidered. Under an IMF balance of payments facility (if approved) there will be little accommodation to encourage the setting up of a welfare state.

By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at
bshoulton@fcia.com

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