# Major Country Risk Developments
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## Overview

The impact of Covid-19 on global growth, supply chain efficiencies, trade flows and overall commercial activity, show signs of extending into the medium-term. Worldwide job losses, weak global demand, price weaknesses, weakened currencies, revenue and investment declines and heavy debt loads are collectively laying the groundwork for a global recession. Projections for total global GDP contraction of 7% in 2020 is increasingly being viewed as conservative. A quick turnaround from recession in 2021 now appears doubtful. It is unlikely that there will be a mere a dip in economic activity in 2020 (due to the pandemic) to be then followed by a sharp recovery. Instead, we expect the contraction to give way to a recession before a gradual recovery begin to take form over 2021-22.

In the meanwhile, the expectation is for intermittent product/goods shortages due to supply-chain disruptions, production cuts, plant closures and mining interruptions, occurring at one or more of the stages in the supply and distribution chains. These bottlenecks will lead to price fluctuations, distortions and more uncertainty. We expect occasional price spikes, even when overall global demand may have declined. Prices will be determined at times by where an end-user may be located vis-a-vis supply-chain and distribution linkages.

Bankruptcies are expected to climb at home and abroad due to loss of market share and insufficient demand around the world. High corporate and sovereign debt levels coupled with weak demand and loss of confidence are expected to lead to a jump in requests for debt reschedulings and payment extensions over the next year.

Moody's predict that companies across the emerging markets could default on their debt at a greater rate than during the global financial crisis over the next 12 months. The rating agency expect that 13.7% of speculative-grade corporate bonds in emerging markets will sour in the year to March 2021. That high end of the estimate would narrowly exceed the 13.6% default rate seen at the peak of the 2008 crisis. The global spread of the coronavirus has led to business closures and restrictions on social interactions across countries. The collapse in demand has weakened EM corporate profitability and liquidity. The default rate for risky speculative-grade corporate bonds in emerging markets fell to 0.8% last year as just seven companies defaulted. They included Jamaican telecoms company Digicel — which extended the maturities of two bonds worth a combined $3 billion by two years — and three Chinese companies.

The pandemic have not yet shown up in default rates, but two sectors likely to be badly hit — retail and oil and gas — had suffered rising defaults even before the virus struck. Other warnings that stress lie ahead is coming from banks. JPMorgan for example, says it expects the banking sector to remain weak over the course of this year, raising its forecast for the gap between yields on riskier emerging-market corporate bonds to 7 percentage points over U.S. government bonds, from a previous forecast of 4.35 points. That would mark only a mild recovery from the current rate of about 8 points. The bank cites the prospect of rising default rates, and forecasts that the pressure on high yield sovereigns is likely to trickle down into corporates, through relative spreads and a deterioration in the macroeconomic environment.

Some remain bullish and consider the Moody's estimates as being too high. They argue that the EM high-yield index has changed dramatically since 2008, when it was skewed towards default-prone Latin America, rather than towards Asia as it is now. And while companies from Argentina — seemingly heading for a sovereign default — account for 2% of the index, other struggling countries such as Lebanon and Ecuador are virtually absent, limiting the risk of contagion. Moreover, banks in emerging markets, which made up a large slice of the high-yield index, are considered today to be stronger than they were during the 2008 crisis. Many are receiving liquidity support from their central banks.

Meanwhile, corporate leverage has declined since the peak after the [EM sell-off of 2013] and it is believed to be more manageable today. This is due in part, to several corporate issuers tapping the bond market in 2019, thereby strengthening their balance sheets. Some high-yield EM companies reportedly typically have cash on their balance sheet equivalent to a quarter of their debt, compared with just 9 per cent for speculative-grade U.S. companies, so they are deemed to be in a better position to cope with shocks. This will be tested in the year ahead.

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While some airlines, hotels and retailers face default, unless the disruption lasts a year to eighteen months, the default risk may taper off and not be as high as in the 2008 crisis. Current EM's bond spreads imply a default rate of 7.5% over the next year, making the asset class relatively cheap. Default rates in developed markets could likely tower over that of emerging markets as a result of the coronavirus crisis.

## USA

Approximately thirty three and one half (33.5) million workers in the U.S. filed for unemployment benefits over the first seven weeks of the lockdown, put in place to combat the coronavirus pandemic. Recent layoffs caused nonfarm payrolls in April to fall by 20.5 million and the unemployment rate to climb to 14.7%. These numbers are the highest on record since the late 1930s and 40s. The previous peak unemployment rate was 10.8% in 1982. The largest monthly jobs loss, 1.96 million, occurred at the end of World War II.

As coronavirus closures continue to put some businesses on life support, the record number of people filing unemployment claims have overwhelmed state labor departments. The dramatic decline in payrolls means that U.S. employers have in one month cut all the jobs they added over the past decade. Combined, the most recent figures show a sharp reversal in the labor market since February, when joblessness was at a half-century low of 3.5% and the country notched a record 113 consecutive months of job creation.

The speed of the downturn is phenomenal and the pressure facing corporations on the heels of an economic slump that could be the sharpest in a century, will likely do great damage to companies, households, communities and to the economy. The pandemic has unleashed fears that far exceed the 2008-09 financial crisis, as companies and workers now brace for the possibility of fresh economic and market pain even after the pandemic subsides.

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According to a study conducted by the Federal Reserve 42% of U.S. non-financial companies are considering slashing investments. A separate survey of small businesses concludes that 52% expect to be out of business within six months; while 33% consider recent staff reductions will be permanent. Corporate bankruptcies are already on pace to exceed levels in the last recession.

Businesses are contending with a collapse in demand (and resulting job losses), supply disruptions and persistent uncertainty over the timeline for reopening the U.S. and economies around the world. Trade, which had slowed consistently over the past 3-4 years will plunge in 2020; and while most projections anticipate some level of turnaround in 2021-22 the force of that recovery remains tentative at this point.

To be sure, there appears to be a definite shift/push toward reopening that is beginning to take form across the world. China, South Korea, U.S., Russia, New Zealand, France, Italy, et al. have taken select steps by regions – a process that seems certain to pick up pace over June-July. As the number of deaths and new infectious cases recedes the momentum to reopen will grow stronger. There are reports of a recent pick up in domestic tourist travel within China and an uptick in demand for automobiles. Chinese exports also picked up slightly in April. These initial signs of green shoots appearing are only that.

Renewed tensions between the U.S. and China, the world's two largest economies, or the possible return to escalating tariffs, would be a major threat to the pace and strength of a global economic recovery [over the next few years]. Trust between the two rivals had deteriorated before and worsened during the pandemic. Many conclude that this bilateral relationship is now at its lowest point diplomatically since 1979.

Despite the best efforts of ideological warriors in Beijing and Washington, both countries are likely to emerge from this crisis diminished in stature and credibility. Both powers are likely to be weakened at home and abroad. The result could be a steady drift toward chaos across issues ranging from international security to trade to pandemic management. With no one directing traffic, various forms of rampant nationalism could take the place of order and cooperation. The chaotic nature of national and global responses to the pandemic serves as a warning of what could emerge on an even broader scale. Maybe cooler heads will prevail. Lately, there have been statements in the press suggesting that trade talks between both countries have resumed.

The U.S. handling of the pandemic has left the impression around the world of a country unfocused and seemingly less than capable of handling this crisis with confidence. U.S. credibility and its profile as a global leader in medicine, science and as a problem solver have taken a hit. Politically, the U.S. appears set to emerge from this period as a more divided rather than a more united nation, as would normally be the case following a national crisis of this magnitude. The continued fracturing of the American political establishment adds a further constraint on U.S. global leadership going forward.

Meanwhile, conservative estimates see the U.S. economy shrinking by between 6 % and 10% in 2020 [some projections go as high as 14%], the largest single contraction since the demobilization at the end of World War II. Washington's fiscal interventions meant to arrest the slide already amount to 10% of GDP, pushing the U.S. ratio of public debt to GDP toward 100% - close to the wartime record of 106%.

The U.S. dollar's global reserve currency status enables the government to continue selling U.S. treasuries to fund the deficit. Nonetheless, large scale debt sooner or later will constrain post-recovery spending, including on the military. There is also the risk that the current economic crisis will morph into a broader financial crisis, although the Federal Reserve, other G-20 central banks, and the International Monetary Fund appear to have so far managed to mitigate that risk.

## China

China's national power has taken a hit from this crisis on various levels. The outbreak has opened fissures within the Chinese Communist Party (CCP), prompting thinly veiled criticism of President Xi's highly centralized leadership style. This is reflected in a number of commentaries that have appeared in public within China during April. Internet debate rages on the precise number of people who died and how many were infected with the virus in China. The published numbers in circulation are suspect and considered well below actual case levels. There is debate raging also on the risks of a likely second-wave as the country slowly reopens, and over the future direction of economic and foreign policy.

The economic damage to China has been massive. Despite published return-to-work rates, no amount of domestic stimulus in the second half of 2020 will make up for the loss in economic activity during the first-half of this year. Drastic economic retrenchment among China's principal trading partners will further impede economic recovery, given that pre-crisis, the trade sector of the economy represented 38% of GDP.

On balance, 2020 GDP growth is likely to be around zero – the worst performance since the Cultural Revolution five decades ago. China's debt-to- GDP ratio already stands at approximately 40%, acting as a drag on other spending priorities, including education, technology, defense and foreign aid. All of this comes on the eve of the CCP's centenary celebrations in 2021. The leadership had previously committed to double China's GDP over a decade. The pandemic now makes that impossible.

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China is now working overtime to repair the enormous damage to its global standing that resulted from the origin of the virus on its territory, and Beijing's failure to contain the epidemic in the critical early months. Furthermore, China's attempts to cover up the whole matter and the use of propaganda to pin the blame on others (for example the U.S.), has only damaged its image further. The reality is that China's standing internationally has taken a huge hit. Anti-Chinese reaction over the spread of the virus, often racially charged, has been seen in countries as disparate as India, Indonesia, Iran, the Caribbean, to name a few. Chinese soft power runs the risk of being shredded.

In **Latin America**, the region has had varying degrees of success in containing Covid-19. However, amid mounting political and economic pressure, and in the context of limited room for continued stimulus, policymakers across the region are now assessing how best to lift quarantine measures and to pave the way toward gradual economic normalization. We should not expect an easing of nationwide lockdowns to imply a return to "business as usual" anywhere in the region. By contrast, poorly implemented exit strategies could produce a second wave of coronavirus infections, further delaying prospects of economic recovery.

There is still no clear indication that the coronavirus caseload has peaked in region. With the possible exception of Argentina, the number of daily infections in Latin America's seven largest economies continues to trend upwards.

## Brazil

The country's short-term outlook has switched again to negative. The economy is on track to return to recession in 2020, for the second time in five years. On May 6th the Brazilian central bank cut interest rates for the 7th consecutive time since July 2019. It reiterated that the moment required unusually large mon-

etary stimulus and acknowledged that there may be limited space for additional cuts.

Amid widespread capital flight from emerging markets, and the real's mantle as the worst-performing global currency this year, the latest interest rate cut is putting pressure on the currency. With interest rates already at historic lows before last week's reduction , it is unclear whether the measure will stimulate lending much, but it will provide relief by reducing debt-servicing costs.

A collapse in domestic demand provides a deflationary environment, giving policymakers room to pursue aggressive interest rate cuts. Consumer prices were flat in March-April, taking the 12-month rate to 2.9%, its lowest rate since 1994. Market expectations are for inflation to ease to 2% by end-2020. Although the rate setters acknowledge the potential for disinflation, it also pointed to the prospect of a worsening fiscal scenario pushing inflation up, as government efforts to quell the effects of the pandemic-along with frustrations over stalled reform efforts-could contribute to increased risk premiums and greater than projected inflation.

Meanwhile, President Bolsonaro faces the possibility of impeachment proceedings as his support slips over his mishandling of the coronavirus. The president is accused of influence peddling by seeking to interfere with police investigation involving his family. The most recent dust up between the president and his departing Justice Minister (and former judge Moro) charges that the president removed the head of the federal police who was investigating Bolsonaro's son(s) on corruption charges. This new episode places Brazil's tattered reputational risk on the hot seat once again.

This will hurt some Brazilian entities' ability to raise capital cheaply on international capital markets, while undermining confidence in the country's political leadership.  Ongoing economic weakness, combined with the threat of rapidly rising Covid-19 infections in the coming weeks, have led to companies putting their investment plans on hold in Brazil. Meanwhile, weak global demand will likely dampen Brazilian mineral and raw material exports. Agricultural exports may suffer only modest declines in volume over the next year, but commodity prices will stay subdued. The weakened Brazilian currency, the real, is unlikely to strengthen over the course of 2020. Foreign exchange reserves remain fairly robust for now. However, if Brazil's exports were to weaken over coming months and if loss of confidence were to trigger a renewed flight of capital, FX reserves would experience declines.

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Brazil appears likely to remain more reliant on China to buy more of its agricultural exports in the year ahead (not less). This will require a delicate balancing act as President Bolsonaro came to office promising to push back against China's increasing leverage over Brazil (as a targeted investment destination) and as the leading importer of Brazilian agriculture and raw materials. Nearly 50% of Brazil export revenues comes from China; that figure rose by a notable 28% year-on- year. Agricultural exports rose impressively in April; in year-on-year terms, the value rose 60% and the volume rose 70%. April's trade data revealed some weakness in export earnings. Earnings from exports to the U.S. and South America were down by 31.7% and 44% year- on- year respectively.

A significant monetary impact on the economy may come from a series of liquidity measures taken since mid-March, including:

- A Banco Central do Brazil liquidity injection of $210 billion to banks.
- A reduction in reserve requirement ratios on time deposits from 31% to 17%.

- A $40 billion increase in credit lines by state-owned Banco do Brazil; and
- A $7 billion National Development Bank credit line to micro, small and medium-sized enterprises.

## Turkey

The immediate concern is whether the Turkish authorities will be forced to introduce capital controls in 2020. In recent weeks Turkish regulators shut out select foreign banks from participating in the local debt/currency markets. Turkey has been historically heavily reliant on liquidity from foreign banks to finance its stubborn current-account and budget shortfalls. The recent moves by Turkish regulators could make other foreign banks/creditors pull back from the market out of fear of more government interference in the private sector. More troubling would be leaving the impression that the Turks are taking an anti-western or anti-American stance. Three of the banks banned from market participation were American.

At best, the latest moves represent bad timing on the part of Turkish financial sector regulators. At worst, the move could remove goodwill that remains between Turkey and its western political/financial partners.

Merchandise exports fell in April by 41.4% y/o/y and imports by 28.3% according to customs data. There were unprecedented demand declines amid widespread lockdown measures and economic uncertainty in Turkey's main export markets – coupled with border controls, transport bottlenecks and supply-chain disruptions – caused exports to fall to just $9 billion in April from $15.3 billion in April of 2019. Imports fell to $13 billion, from $18.1 billion in April 2019. This caused the trade deficit to widen to $4 billion from $2.7 billion in April last year.

Receipts from automotive exports, Turkey's largest merchandise export item, came in at just $518 million as a result of temporary factory closures. This compares with $2.3 billion exported in April 2019. Exports to France, Spain, the UK and Italy (which accounts for 20% of all Turkish exports) were down by more than 50%. Exports to Germany and the U.S. declined by 35.9% and 25.1%, respectively. The current account deficit balance is forecast to deteriorate amid the anticipated collapse of Turkey's tourism sector which brought in $35 billion in FX earnings in 2019.

### The Turkish banking sector performed well in the first quarter of 2020 following a poor performance in 2019 ...

The Turkish banking sector performed well in the first quarter of 2020 following a poor performance in 2019: growth in bank assets accelerated to 2.3% year on year in real terms and the volume of credit (excluding inter-bank credit) rose by 9.1%. State banks expanded their loan books by 10.7% and accounted for 37.4% of total credit expansion. Aggregate net profits in the sector amounted to $2.4 billion in the first quarter, despite exchange-rate losses of TL9.2bn, which compares to 2019 annual profits of TL49bn. The sector's capital adequacy ratio remained high, at 17.9%, but declined slightly from 18.4% at the end of 2019. According to the BDKK, the non-performing loan (NPL) ratio in March fell to just under 5%-from 5.3% in December 2019, but the decline may be partly attributable to more lenient treatment of debtors in line with government policy.

Turkish banks will come under considerable pressure in 2020 owing to the impact of the coronavirus epidemic and the subsequent recession. Nevertheless, Turkish authorities are insisting that banks continue to expand lending aggressively, defer loan repayments, purchase government bonds and step-up swap transactions with the central bank. The BDKK started penalizing banks that do not meet its new "asset ratio" of 100% from May 1st, which effectively forces banks to pool all their resources available

to support the economy via credit expansion. The ratio is calculated by summing a bank's entire loan book value, 75% of government bond holdings and half of all swap transactions with the central bank divided by all Turkish lira deposits and 125% of foreign-currency deposits. Meanwhile, banks face lower non-interest income from fees and charges, which have been reduced significantly to encourage electronic payments and eliminate congestion at bank branches. The central bank's 200-basis-point rate cut to 8.75% in February-April will further weigh on net-interest margins.

The number of foreign nationals arriving in Turkey declined by nearly 65% year on year, to less than 1 million in March, from over 2.7 million a year earlier. The tourism industry accounts for about 12% of GDP- and was set for another strong year, following robust growth in foreign visitor arrivals in the off-season months of January-February. However, for the remainder of 2020 the sector is bracing for a lost year amid the containment efforts to slow the spread of the coronavirus, which has led to blanket restrictions on international travel. Over 70% of Turkey's foreign visitors typically arrive in May-October and about 30% in July-August.

The severe 64.7% year-on-year drop in foreign visitor arrivals in March came despite only gradual restrictions imposed on international flights. The number of countries to and from which flights were prohibited was increased from 22 to 68 on March 1st, but by the end of the month all regular flights were halted. According to the Turkish Statistical Institute, first-quarter tourism revenue was $4.1 billion-an 11.4% year-on-year decline-and March revenue at $787.8 million; a 53.2% plunge.

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In 2019 foreign visitor arrivals totaled 45.1 million, tourism earnings were $34.5 billion and Central Bank of Turkey balance-of-payments figures recorded gross travel revenue of $29.8 billion (4% of GDP). Tourism revenue plays a crucial role in Turkey's external balances: in 2019 net travel revenue of $25.7 billion more than offset the goods trade deficit of $16.6 billion. Although imports are expected to fall sharply in 2020, Turkey will nonetheless have to forgo an important source of foreign currency needed to service foreign debt obligations.

Turkey is considering easing lockdown restrictions by mid-May, which may allow for some domestic tourism. However, international flight bans are likely to persist for longer: flights by Turkish Airlines, the national carrier, are currently cancelled until May 28th. Even if the bans are eventually eased, demand for international travel will likely be sluggish in most of Turkey's major markets in Europe, owing to the economic and psychological effects of the pandemic.

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