Major Country Risk Developments
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Overview

The world appeared to be slowly emerging from the Covid-19 pandemic that has resulted in the most severe global economic contraction since at least the 1930's. However, a recent spike in cases recorded in countries that seemed in recovery mode, is causing some misgivings.

The pandemic will have a large and lasting negative effect on the global economy. 2020-2021 will be mostly lost years in terms of growth. A sustained recovery will likely take three or more years. Moreover, the pandemic will place a heavy fiscal burden in both developed and developing countries.

Where lockdowns have eased and the virus is under control, economic activity is starting to pick up [China, parts of Asia] - but because there is a lag of weeks to months between when official economic data is produced and the period of time it covers, it is mostly out of date before it is published.

Global trade volumes will fall by approximately 16% this year, according to the Economist Intelligence Unit. Supply-side shocks emanating from lockdowns across Asia, Europe and North America have generated severe disruptions to global production, while demand has cratered amid social distancing measures, job losses, bankruptcies, and uncertain business/consumer sentiments.

All regions will record significant trade weakness this year, with particularly painful shocks rippling across North America, Western Europe, Latin America and the Middle East. Asia has struggled but will likely see comparatively less economic disruption as China exits the pandemic more quickly than elsewhere.

Chinese economic normalization will support regional demand for commodities imports tied to infrastructure investment, as well as agricultural products to satisfy food control goals. The restart of Chinese factory activity has also minimized intra-regional supply-chain disruptions, supporting wider Asian trade flows and keeping local exporters competitive as extra-regional rivals have often gone offline.

However, China's expected economic recovery will not fortify global trade flows in 2021 to the same extent as during the global financial crisis. Nonetheless, current trend suggests that global trade activity has firmed over the third quarter of 2020 as other major markets emerge from lockdown. Backlogged orders are now being shipped and delivered globally and the ability to process new orders is being slowly restored. Meanwhile, uncertainty remains the prevailing sentiment as layoffs continue across a variety of sectors; previous layoffs have become permanent, and a vaccine is yet to be approved.

With some global demand expected to return in 2021, we should see an initial uptick [due to pent up demand, and the need to rebuild inventories], to be followed by a leveling off of activity. Trade prospects in 2021 are inherently tied to successful Covid-19 mitigation. The trade outlook is tied to the efficacy of global containment measures. Any future outbreaks (and lockdowns) would derail a sustained recovery, with a recent rise in Covid-19 caseloads across Europe and Asia – including in major trade hubs such as Hong Kong, Vietnam and Japan- illustrating the fragility of containment.

Household spending makes up the largest part of the economy in most countries, and any recovery largely depends on consumers regaining the confidence to increase spending from ultra-low levels. Mobility data - which tracks traffic from retail and entertainment hubs is considered a proxy for consumer spending. It shows that people have returned to spending venues, but with large variations between countries.

However, retail spending is a small share of total household spending, and during the pandemic some consumers have preferred to purchase goods, such as groceries, instead of services, such as restaurant meals. Therefore, even a full recovery in terms of overall spending will not indicate a return to regular retail spending patterns. The human cost of the pandemic has continued to mount, with more than 33.6 million cases confirmed globally and more than one million people known to have died. The negative impact on unemployment will remain a drag on global confidence, consumption, and a return to economic growth.

Growing trade diversification, amid recognition of the dangers of supply-chain over-reliance on China, will gain further traction in 2021. The consensus does not expect a mass corporate exodus from China, nor significant reshoring to expensive Western locations. However, "nearshoring"- as supply chains become more regionalized -will underpin export and import activity in 2021-22. The longer-term economic effects of the pandemic, however, risk putting a cap on a sustained trade rebound. This will reflect the hits to household incomes, high unemployment, and weak business confidence. A combination of growing political wrangling over continued policy support (such as in the U.S.) and expected strains in fiscal capacity (across many emerging markets) could similarly hamper an enduring recovery. This could keep trade flows below pre-crisis levels until 2023.

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Meanwhile, an expected pick-up in trade flows in 2021 could create space for trade policy disputes to reignite- particularly as the pandemic has sparked an uptick in protectionism. Governments are reassessing their approach to globalization, including calls for supply-chain reshoring, imposing restrictions across certain exports and imports, and heightening scrutiny of foreign direct investment (particularly from China).

Some major markets including China, India and the U.S. – are now emphasizing the importance of domestic production as part of goals to reduce their reliance on foreign goods. The pandemic has caused economic policy to become more domestically oriented, and this trend will be difficult to reverse amid heightening geopolitical tensions. U.S.-China ties remains the biggest (non-pandemic) threat to trade. Apart from attempts to get China to buy more U.S. product (aimed at pushing purchases toward pre-trade war levels) which is not going well, frictions in technology, investment and finance continue to escalate. The conflict with China will be a long-term struggle and will remain at the center of the relationship between both countries- no matter the outcome of the November presidential election. As U.S.-China ties deteriorate, third countries will increasingly face the risk of being forced to choose sides. A tough choice considering the importance of both the U.S. and the Chinese markets in the global economy.

Uncertainty persists elsewhere. U.S. frictions with the European Union and other countries over taxing digital services, risk laying the groundwork for future U.S. tariffs.

Consumers are growing more optimistic about the state of the U.S. economy, according to surveys conducted in September. According to the Conference Board, a private research group, the index of consumer confidence posted its biggest increase since April 2003 – reversing two months of decline and bringing the gauge to its highest level since March. The labor market continued to gradually improve and a summer Covid-19 surge receded in

parts of the country. The trend toward more business reopenings in the U.S. should begin to gradually increase economic activity over the coming months.

Although monthly trade data are notoriously volatile, some longer-term trends are clear. We expect cross-border trade volumes to pick up gradually in the coming months as economies recover. However, the U.S. trade balance will remain heavily in the red for the foreseeable future owing to a relatively strong dollar, depressed domestic oil and gas production, and the continuing shift of low-cost manufacturing to Asia and Latin America.

Canada

The gradual relaxation of pandemic-related restrictions in recent months has underpinned a strong initial rebound following a record 11.6% contraction in real GDP during the second quarter. A solid 3% growth in July was half the rate of expansion in June. Growth in August was 1%. All 20 industry sectors recorded gains during the last quarter; and the retail, agriculture, utilities, real estate and finance sectors have more than recovered the output lost since February.

Construction output also rose as an expansion in residential building more than offset lower non-residential construction and engineering. This points to continued subdued business investment. The oil and gas sector continued to struggle, with extraction activity falling for the fourth time in five months, pushing monthly output back to 2017 levels.

Accommodation and food services which slumped during the spring lockdown, enjoyed three months of consecutive double-digit growth, as consumers became more comfortable with the new health and safety protocols. Still, commercial activity is well down from the pre-pandemic level. The forecast is for GDP to contract by 5.8% in 2020 and grow by 4% in 2021.

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Meanwhile, the number of Covid-19 cases have picked up steadily in recent months, fuelling concern about a second wave. In September new cases rose to their highest levels since May. The province of Quebec was the worst-affected during the initial wave of the virus and appears to be heading that way again. To curb the spread, the provincial government put Montreal and Quebec City on red alert. This means a tightening of operating restrictions at bars & restaurants, and a limit on private gatherings of six people, among other measures.

In Ontario, Canada's most heavily populated province, the number of new cases topped 400 on September 18th, for the first time since early June. Private indoor gatherings are now restricted to ten people, and fines have been introduced for non-compliance. Across Canada, new daily cases have risen from a low of about 250 per day at the beginning of July to 911 by September 21st – the highest since late May. The spike in cases comes as members of Canada's parliament prepared to return to the House of Commons for the reopening of the legislature. Leaders of two of the three main political parties could not attend as they both tested positive for Covid-19.

Although no repeat of the strict lockdown imposed early in the year is expected, local restrictions are being tightened. It is the belief that this approach is less damaging to the overall economy than during the first wave. However, there continues to be concern that a significant second wave could derail the economic recovery. The hospitality sector will be dealt a further blow from a 28-day partial lockdown of three regions in Quebec which went into effect October 1st.

Meanwhile, in September the U.S. removed tariffs imposed on Canadian aluminum. The tariff could be re-imposed if quotas set unilaterally by the U.S. for the next four months are exceeded. The travel ban across the U.S. border will remain in place until mid-2021.

An Economic Recovery Bill was unanimously passed on September 30th. The legislation underpins new federal pandemic benefits that will replace the now-expired emergency response benefits. The passage of the bill is seen as a confidence vote in the sitting Trudeau government. It will help keep afloat those who have lost jobs since March. Meanwhile, a wave of mortgage defaults is anticipated in 2021.

The economic recovery in 2021 promises to be bumpy and uneven across sectors. GDP is not expected to recover to its 2019 level until 2022 earliest. The travel and tourism industry will remain under pressure from the slump in global and domestic travel and restrictions on non-residents entering the country. The government's response to the pandemic and its other policy plans come with a big price tag. The deficit for fiscal year 2020/21(April-March) is now likely to surpass 17% of GDP. In 2021 there will be a greater scrutiny of the surge in borrowing by the federal government, and the lack of a plan, so far, to consolidate the hefty budget deficit and contain the growing pile of debt.

Europe

Covid-19 related deaths in Western Europe overtook Asia's earlier lead, making Italy, Spain and the UK global hotspots. As lockdowns ease and borders reopen across Asia and Europe, flight and hotel occupancy data show international mobility slowly resuming. However, the latest data suggests that travel reservations have been negatively impacted by a resurgence of Covid-19 in many countries, with people remaining cautious about their future travel plans.

Public health officials are sounding the alarm over a resurgence of coronavirus cases in Europe as countries ease lockdowns and international travel ramps up; while some experts warn that people have become too complacent. The increase is marked in countries such as Spain, while Eastern Europe and the Balkans, which were largely spared the worst of the early pandemic, are seeing a steep increase in recorded cases. The British prime minister has warned of a looming second wave of Covid-19 across Europe, while the head of Germany's public health authority strongly advised citizens to not let their guards down. Governments are already taking additional measures to slow the spread.

The European Union agreed on a European economic recovery fund, which clears the way for joint debt issuance (worth $800 billion) to be channeled to the less-developed countries in Europe and those hardest hit by the pandemic. Around $400 billion will be transferred via grants and $400 billion in loans. The size of the fund is modest given the size of the economic shock, but it will increase fiscal space in highly leveraged countries. Moreover, the fund is a landmark step for the bloc, as it establishes a precedent for the EU to issue debt to fund common needs. Germany's change of heart on joint debt issuance was crucial, but the size and nature of the Covid-19 shock also helped to make this possible.

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The German lockdown was comparatively short – six weeks, versus eight weeks in France, Italy and Spain – a difference that has had a significant economic impact. The German economy is projected to contract

by 5.9% this year, as a result of the supply-and demand side shock resulting from the pandemic. However, second quarter data show that the recession in Germany has been less severe than those in France, Italy and Spain, reflecting a shorter and less stringent lockdown, and massive government support. Germany's large manufacturing sector – equivalent to 20% of gross value added- has proved a structural advantage, with pent-up industrial demand and order backlogs supporting strong catch-up growth since May. The services sector is likely to take longer to recover, with consumers and firms still behaving cautiously, and ongoing uncertainty owing to the need for local lockdowns to contain outbreaks. The expectation is that the German economy will return to its end-2019 size by late 2021, ahead of the EU average of 2023. Nonetheless, significant economic distress lies ahead.

Germany had been praised for its success in containing the pandemic so far, but its crown has begun to slip. The number of new daily Covid-19 cases rose from about 500 in mid-July to 815 daily during September. Previous surges were confined to specific locations such as meat factories or elderly care facilities. But the latest case increases are spread across the whole country. Public health authorities have also expressed alarm at the big increase in infections in countries that weathered the early months of the pandemic relatively unscathed.

German experts are seeing a worrying shift in the demographic of new cases. Many of the first coronavirus infections were among young people returning from holiday in Austria and northern Italy.

It is unclear if Europe is at the start of a second Covid-19 wave. Officials cite the gradual lifting of restrictions on public life across the continent over the past couple of months that lulled people into a false sense of security: many were no longer observing strict hygiene rules, wearing masks in public and maintaining social distancing. The rising infection rates can be linked to the relaxation of lockdowns.

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But the speed of the uptick in parts of Europe has taken some experts by surprise. Some believed we would have seen a lull over the summer.

Spain remains one of the worst-affected countries. It recently recorded nearly 14,000 new cases in a week. France, which reported 6,325 cases in one recent week, is another country where the public is becoming less cautious. It appears that recently the French became laxed in practicing social distancing and caution. Tourists are a particular worry. Officials are concerned that visitors are picking up the virus in crowded bars and nightclubs at resorts in countries such as Spain and spreading it among family and friends back at home.

New restrictions are being brought in to deal with the upsurge in cases. Belgium moved to toughen social distancing and urge teleworking after a spike around the city of Antwerp, where a curfew has been imposed.

The UK has not been exempted from the sharp decline in trade, disruptions to travel and supply-chains which caused both imports and exports to decline sharply in 2020. This will result in the UK's current-account deficit shrinking from the equivalent of 4% of GDP in 2019 to 1.7% of GDP this year.

Beginning in 2021 trade is expected to pick up, although this will primarily be the result of a recovery from a low 2020 base year, and we expect Brexit to weigh on exports (as well as imports, but to a lesser extent). Trade will continue to grow thereafter, but it is not expected that the value of total imports or exports will return to pre-crisis levels until the end of 2024. Lingering questions surrounding Brexit will

weigh on European and trans-Atlantic trade, with a comprehensive U.S.-UK trade deal unlikely in the short term.

Latin America

Latin America is currently the epicentre of the pandemic, accounting for almost 40% of daily fatalities. This has been fuelled by a surge in fatalities in Brazil, Mexico, and several other countries in Central and South America. Consumer demand has plummeted across the region as containment measures imposed by governments exacted a severe toll on the regional economy. Most governments have tried to minimize the demand shock through the implementation of various fiscal support measures. However, these policies have had limited, short-term effectiveness and the consumer recovery has yet to fully take hold.

Latin America's export sectors have been battered, with all major countries seeing double-digit declines in exports. The situation has been much worse for manufacturing exporters, most of which trade heavily with the U.S. and Europe, than for commodity exporters, whose main export partner is China. However, recent monthly trade data suggests that both commodity and manufacturing exporters are starting to recover. Although the pandemic continues to rage unabated in much of Latin America, the lack of appetite for a second lockdown means exporters are likely to remain open for businesses despite the risks.

Imports, however, will remain subdued amid still-very weak domestic demand. From a current-account perspective, this will provide some support, helping to offset capital outflows, stabilize currencies and maintain a solid foreign reserves position.

The region's export sectors are strongly dominated by commodities, which have posted a mixed performance overall. For the most part, agricultural exports have held up well. For countries like Argentina, Brazil and Chile, this has been a boost in a context of still-weak manufacturing and hard commodity exports.

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One commodity that was badly affected even before the pandemic hit is oil, which has seen a slump in prices. Almost all major regional oil exporters reported significant losses in the first-half, and despite some recovery, oil exports remained in a slump in Mexico, Colombia and Argentina. An exception is Brazil, where oil exports rose by 14% in July/August on account of efforts by the state oil company, Petrobras, to diversify to Asia, where demand has remained strong.

The reopening of certain manufacturing activities in Mexico (notably vehicle production) and a further loosening of lockdown measures helped exports to recover some lost ground, leaving them 12.8% down from a year earlier, during the first six months of 2020. By far the biggest hit to Mexican trade came from vehicle exports, which were down by 80% in the second quarter. Production was at a virtual standstill earlier, with exports largely coming out of inventories. But at just 31.7% down since June, some recovery in this critical sector has also been apparent.

Brazil, which has the second largest export manufacturing sector in the region, also saw massive losses of up to 40% during the first-half, although there are signs of a bottoming out, with exports down by less than 23.5% in recent months. By contrast, Brazil's agricultural exports have grown solidly over the course of the year, showing double-digit growth since March. Overall, Brazil's more diversified trade profile and strong links to China have resulted in its export performance being the most resilient of any country in the region aside from Chile.

The sharp decline in imports is largely explained by the fact that infection curves in most of these coun-

tries have failed to come down. This means domestic economic activity (and import demand) remains constrained, independent of the extent to which lockdowns have been eased.

Although Latin American governments are now in the process of reopening their economies, the expectation is for unemployment to remain high.

Against this background, we expect consumption to recover gradually to pre-crisis levels. The recovery will be uneven, with some business failures, while survivors adjust to changed consumer behavior and purchasing habits. For example, the pandemic is dramatically accelerating the shift from brick-and-mortar retail to e-commerce. Recent online retail-sales transactions in the region are up 23% above the average level in January-February. The consensus is that among the largest LATAM economies - real private consumption will return to pre-pandemic levels fastest in Colombia, Peru and Chile.

Peru

After initial volatility in 2020-21 due to the pandemic, average GDP growth is projected at 4.1% over 2022-30. Growth is expected to ease to an average of 3.1% over the following decade. The export-oriented sectors of the economy, ranging from mining to agriculture, have been the most dynamic over two decades. The expectation is that Peru will continue to benefit from free-trade agreements (FTA'S) with the U.S. (its main market for non-traditional exports) and China, which replaced the U.S. as the recipient of the largest proportion of total Peruvian exports. FTA's with the EU and other Asian economies will provide similar benefits. Although rapid GDP growth over the past two decades has enabled Peru to catch up with the Latin American median in terms of GDP per head, its GDP is still well below levels in developed countries. Weaker external conditions and slow progress in

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pushing a reform agenda forward to tackle long-standing structural issues- mean that Peru will still lag developed economies.

Peru's export earnings were still down this year on the back of a mining sector that is struggling to emerge from harsh quarantine measures to combat Covid-19. The country's copper export volumes were around 20% down year-on-year during the first-half of 2020. Future growth is likely to be focused in resource intensive areas, exports of agriculture and specialized areas of manufacturing, such as textiles.

Peru is well endowed with natural resources, ranging from metals and natural gas to productive agricultural land. Its main weaknesses are the poor quality of its institutions and widespread income and regional inequities. Low education and capital investment levels, and the slow pace of institutional improvements, will be the main factors behind a slowdown in average annual growth this year and next. Coupled with low spending on research and development (less than 1% of GDP), this will constrain Peru's economy from moving into higher value-added areas, despite frequent attempts by governments to improve domestic productive capacity. Economic performance will become more dependent on productivity gains as growth in the labor force slows and the economy remains reliant on the extractive sectors. Peru's increasing integration into the world economy should allow the country to benefit from global demand as it picks-up pace in 2022-24.

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Integration efforts within Latin America are also gaining pace, particularly via the Pacific Alliance (an integration pact comprising Peru, Chile, Colombia and Mexico), which focuses not only on trade in goods, but also on services, capital, and free movement of people.

Although the economy is highly exposed to world commodity prices, the country's vulnerability to external shocks will be partly mitigated by greater export-market diversification, as well as investments in supply expansion of non-traditional exports. Opportunities in energy and mining will continue to foster investment. Nevertheless, with export-oriented industries being the mainstay of the economy, Peru will remain vulnerable to fluctuations in external demand and commodities prices. The gap in economic opportunities between Peru and a variety of countries (including the U.S. and neighboring Chile), will remain wide. While great strides have been made in developing the economy over the past two decades, the quality of Peru's institutions remain weak, characterized by a politicized judiciary, widespread corruption, and the lack of a strong party system, which leads to legislative fragmentation.

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