Major Country Risk Developments
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By Byron Shoulton

Overview

An uneven rebound in global trade continues, facilitated by the ability of factories around the world to adapt to the pandemic. In the U.S. as vaccine rollouts gain momentum, more states and municipalities are easing lockdown rules and increasingly moving toward opening up services. With increased numbers of vaccinations delivered, more people are expected to return to the workplace over the next three to six months, as the urgency for remote work is gradually reduced. The economic outlook has improved marginally with manufacturing performing well, more vaccines available, and progress on the latest pandemic relief bill advancing; together these factors have contributed to boosting business and consumer confidence.

The U.S. manufacturing purchasing managers' index for February came in at 60.8%, up 2.1 percentage points from January's reading. This is by all accounts a blockbuster number – the highest reading since February 2018. A close look at the Institute of Supply Management's survey reveals that supply chains seem to be the central concern for businesses surveyed. For example, one respondent in the transportation equipment segment observed that steel prices have increased significantly in recent months, driving costs up for suppliers on new work that they are bidding on. In addition, they revealed that the tariffs and anti-dumping fees/penalties "are being passed on to us".

Another company producing machinery also experienced rising prices for inputs and reported that lead times are growing longer by the day. While business and backlog remain strong, the supply chain is going to be stretched very thin in order to keep up, they said.

A third company engaged in primary metals, reported that new orders have increased 40% over the last two months. The company is overloaded with orders and does not have the personnel to get product out the door on schedule.

Bottom line: demand is robust but producing goods for customers is proving problematic. This has knock-on effects on costs. The survey revealed that the costs of raw materials are up a whopping 86%. If producers manage to pass on those higher costs to consumers, then the rise in inflation will become stronger. Add to that higher oil prices and pent-up demand for services – together these will in all likelihood trigger a rise in consumer price inflation over the coming months.

The optimism around a global expansion helps to explain concerns about a spike in inflation, however nascent, and the prospect that central banks may have to adjust their stimulative policies. While we have no idea where inflation will settle, a spike seems as good a bet as any in this economic environment. This may help explain a swift and powerful bond market rout which unfolded in late February. The 10-year U.S. Treasury yield [arguably the most important interest rate as it influences prices in virtually every financial market] jumped from under 1% at the start of the year to over 1.6% amid tumultuous trading. Mortgage interest rates have also edged upwards since.

In **Europe** purchasing managers have indicated that manufacturing activity is continuing to pick up. However, many companies in the services sector, which rely heavily on local demand and export little, are struggling to cope. This is largely due to government-enforced closures, which remain in place in many of the eurozone's largest economies, including Germany and France. Meanwhile, recent weak jobs

and retail data have raised the possibility of a double-dip recession in the Eurozone. Spanish unemployment hit four million for the first time in five years, while German consumers scaled back spending for two months in a row. Tight restrictions and closure of non-essential stores and restaurants in Germany triggered a 4.5% fall in retail sales in January. The end of a temporary cut in sales taxes also weighed on consumer spending.

The less than buoyant results caused the European Central Bank to lower its growth forecast for the first-quarter of 2021, while anticipating a rebound in the second-half of the year.

Meanwhile, **China's** Huawei Technologies has notified its suppliers that its smartphone component orders will fall by 60% in 2021 from levels achieved in 2020. This, as a result of U.S. sanctions imposed against Huawei by the Trump administration. The company's component orders have been limited to those for 4G models as it lacks U.S. government permission to import components for 5G models. Some suppliers expect actual 2021 production by Huawei to be even lower than current projections. China's largest handset maker is suffering from U.S. sanctions which the Biden administration appears to back. The U.S. Commerce Department in early February said it saw no reason to remove blacklisted companies from the department's Entity List because most were included on it for national security or foreign policy reasons.

The embattled Chinese tech giant last year fell to number three in the global smartphone industry, behind Samsung and Apple, according to research company IDC. Huawei is likely to lose further ground in 2021 given the U.S. export restrictions. Global semiconductor and components shortages are also weighing on Huawei's smartphone business. While some suppliers have obtained permission from U.S. Department of Commerce to ship parts, Huawei still lacks access to core components for 5G models. There are news reports that Huawei could sell its mobile phone business altogether. Huawei denies those reports.

There will be a new focus on supply chain security in the U.S., which promises to be an important theme of the next few years. How much energy and money the U.S. will devote toward stimulating domestic manufacturing across critical industries such as semi-conductors and medical equipment, among others, remains debatable. This, along with assurances that the U.S. has access to critical materials and components from allied countries will remain high on the trade/security agenda.

Myanmar

Citizens in Myanmar [formerly Burma] are hoping for a tougher global response to the military's seizing power in a coup on February 1. The situation in the country is deteriorating fast, as the economy takes a hit. Voters in Myanmar are refusing to accept being deprived of their political choice after Aung San Suu Kyi's National League for Democracy [NLD] won an overwhelming victory in parliamentary elections last November. Banging of pots and pans are heard across the country almost nightly following the February 1 coup. Thousands have joined protests braving violent arrests. As protesters continue to face down the police and army in ongoing demonstrations to dispute the army's claim that the election was marred by fraud, violent arrests in confrontations across the country have left over 40 people dead. Women have reportedly added spine to the civil disobedience movement that is crippling the functioning of the state.

The military has crushed protests with live rounds, stun grenades and tear gas, according to news reports. In response, thousands have refused to work, including bank employees, civil servants, medical staff, doctors, teachers, garment workers – causing the systemic unravelling of the economy that is now taking place. Workers' strikes have brought the banking sector almost to a halt, which will complicate life and cause economic dislocation by making it difficult to make payments to businesses and workers. All of this may make it more difficult for the coup leaders to turn back the country to its authoritarian past.

Meanwhile, the military has stepped up its political campaign against civilian leaders who have led the government since elections in 2015. Deposed leader, Aung San Suu Kyi has been hit with new charges of making statements that "may cause fear or alarm", on top of previous curious allegations of illegally importing walkie-talkies and violating a natural disaster law by breaching Covid-19 rules. The initial charges carry three-year jail terms. It would also ban her from holding office.

In theory, Myanmar's future course should only be settled by its people. From all indications the people are not backing down from confronting the military junta. Yet foreign governments and institutions are being urged to help formulate a coordinated and effective response to the coup. Starting with engagement with the military regime, with a view toward returning Myanmar to civilian rule and establishing a mechanism to achieve that goal. There will need to be dialogue, but some are ruling out any with generals who seized power at gun point. Opponents of the junta are also urging support for a global arms embargo, barring the direct or indirect supply of weapons or other form of military assistance to the regime.

China, the largest arms supplier to Myanmar, vetoed an initial UN Security Council Resolution condemning the coup (though it later supported one calling for Aung Sung Suu Kyi's release). China would likely block a resolution on a weapons ban. But other countries are being prompted not to supply arms to a military that is using the arms against its own people. The U.S., UK, EU and others have begun rolling out sanctions against the military and the army's business allies and interests.

Foreign governments are being urged to follow through on warnings that they will extend/tighten sanctions on the regime if the violence persists. Other governments investigate engaging with the CHPH, the committee formed by NLD parliamentarians who avoided arrest in the coup- and defy orders from the military to refrain from contact. The committee's hope is to form an interim government that can gain international recognition. But this will be complicated by the fact that most of its Members of Parliament are under arrest or in hiding. Many are the representatives of the party that won the elections overwhelmingly. Foreign capitals, business leaders and diplomats will be seeking to deal and engage with these representatives [and not just the generals].

The military junta would find it tough to wield power if Myanmar is cut off from trade, finance and services ties it has with so many countries. Foreign ministers from the Association of Southeast Asian Nations [ASEAN] met recently, but the group did not agree on any significant action, except calling for an end to violence. Four members- Indonesia, Malaysia, the Philippines, and Singapore- called for the release of Aung San Suu Kyi and other detainees.

The U.S. has imposed sanctions on the leaders of Myanmar's military junta. The military is likely to face strong measures from some countries and isolation for the coup. However, the coup leaders already made it clear that the country has survived sanctions in the past. The support of China and Russia in blocking pressure on Myanmar's military is likely to counter any outside pressure.

Mexico

The economy continues to struggle to recover while the policies of the sitting government are discouraging new investment [both domestic and foreign]. There was no economic growth registered during 2019, and the economy contracted by 8.5% in 2020. Among the unemployed in early 2021, there were three million more workers without jobs, compared with the same period in 2020. Furthermore, the size of the informal economy and those that are self-employed was 90% larger in February than it was a year earlier.

The pandemic is only a part of the reason for uncertainty toward investment in Mexico. The policies of the government of President Lopez Obrador [includ-

ing the cancelation of a new airport in 2018; and that of a brewery plant in Mexicali] have hit confidence among investors and contractors while hurting employment prospects. A crisis of confidence will persist as long as Lopez Obrador's nationalist agenda continues to dominate policy. The administration will struggle to make headway on the structural problems that propelled the president to power (crime, corruption, poverty, and income inequality).

In manufacturing, production of light vehicles during the first two months of this year were 15% lower than for the same period in 2020. Orders in February stood at 50.1 points down from 51.2 points in January, a movement that was contrary to the pattern in a number of countries where the manufacturing sectors have begun to thrive again. Imports also fell in January-February, a clear indication that Mexican domestic demand remains depressed. Capital goods imports fell 11% [compared with December] suggesting an anemic recovery in manufacturing.

Mexican exports during January-February were down 24% from December, a fall that occurred while the U.S. increased global imports. This was unusual because as a rule Mexico benefits when U.S. imports pick up. Eventually, Mexican export-oriented manufacturing will grow, as the economic recovery in the U.S.-buoyed by renewed fiscal stimulus in 2021-takes hold. Longer-term prospects for export-oriented manufacturing remain good in view of low wages, a relatively skilled workforce and deep integration into U.S. value chains.

Oil production as reported by Pemex fell 4.7% in January compared to the comparable month in 2020. Recent reported results indicate enormous challenges at the state-owned oil company and the continued inability to achieve its operating objectives. The company reported a loss of $23 billion in 2020 [a loss 38.2% higher than was recorded in 2019]. This has forced the government to inject fresh capital to keep Pemex afloat. There are also examples of the government's cancelation of private companies' participation in oil extraction despite Pemex's ongoing financial and performance problems which prevent it from investing and boosting new production. Pemex accounts for 97% of domestic crude production, while the remaining 3% comes from the private sector. However, while private producers have consistently increased their production levels, Pemex continues to produce less crude. Pemex faces $14.7 billion in debt maturities in 2021. The company has squandered capital, stifled competition and is dependent on government largess to stay in business. All this while President Obrador insists that Pemex is a national icon and whose oil revenues should contribute to the well-being of the Mexican people.

At the same time, the country's state-owned electric monopoly CFE, is expected to be protected further by a new law that seeks to prioritize the state power company over private companies generating electricity in Mexico. The proposed law [Electricity Industry Law] threatens to upend Mexico's electricity market and would endanger billions of dollars in private investment already made in the sector. Experts analyzing the new law have concluded that it will increase the cost of generating electricity in Mexico.

Private companies competing against CFE will be at a serious disadvantage and passage of the bill will remove incentives for private sector participants in the sector going forward. The law would rule out the use of clean energy for electricity supply. The bill has provoked considerable debate because of the priority over power generation that it gives the national electric company and also because it will face myriad legal challenges. Ultimately, at least $9 billion in investments tied to Mexico's previous long-term power auctions could be affected by these modifications.

Although the CFE would benefit from preferential treatment in the short term, end-consumers would ultimately shoulder the burden through higher electricity rates, as the bill would inhibit competition in the energy sector.

On top of the private-sector pushback that the bill is facing, the proposed changes are likely to contravene antitrust principles; as well as violating various bilateral and multilateral investment treaties, including the USMCA and the Trans-Pacific Partnership. President Obrador recently spoke with President Biden in a virtual bilateral meeting and explained that Mexico was seeking energy self-sufficiency.

Despite the government's poor handling of the pandemic, President Obrador benefits from an unblemished personal reputation and voter disaffection with traditional political parties, owing to accusations of rampant corruption. He has capitalized on this by running a public crusade against high-level civil servants of previous administrations for their alleged misconduct. The president's political standing is likely to remain strong ahead of mid-term elections in June 2021. Lopez Obrador benefits from majorities in both houses in Congress based on a coalition of several diverse parties. That coalition holds seven of 32 states governorships and 19 of 32 state legislatures (approval from 17 states is needed to pass constitutional amendments).

A weak opposition have allowed the president to put loyalists in important posts that were vacated following policy disagreements. Although these changes call into question the independence of Mexico's political institutions, they have helped the president to cement his position, reducing risks to governability and improving his Morena party's chances of winning the June mid-term elections.

The economic recovery from the pandemic will be weak in Mexico. GDP growth of 3.5-4% in 2021 is projected. On balance it is not expected that real GDP will return to 2018 levels until late 2023. The consensus is for real GDP growth to average 2.3% per year in 2022-25. The lack of robust fiscal support measures for consumers and businesses in 2020-21 will cause permanent loss to income. In this environment, business activity will likely struggle to return to pre-crisis levels, causing knock-on effects for private consumption amid slow job growth. Moreover, the government's erratic stance on private investment will continue to weigh on investor confidence. This will dampen any recovery in investment, which was already declining before the pandemic hit.

Colombia

Colombia's decade-old status as an investment grade country will be put to the test as the government tries to pass a fiscal reform package to steady an economy that has been buffeted by the pandemic. President Ivan Duque is preparing to present the package to congress in March with the aim of getting it approved by June. If the timetable slips, there is the danger that his proposal will become mired in the country's legislative and presidential election campaigns for 2022, which will begin in earnest later this year.

Rating agencies Fitch and Standard & Poor's both rate Colombia BBB- with a negative outlook for the issuance of long-term debt. That is just one notch above non-investment or junk status. Moody's rates Colombia Baa2, two notches above junk.

If the reform flounders or gets diluted, there is a high chance Colombia will get downgraded – demoted from a small group of Latin American investment grade nations that includes Mexico, Chile, and Peru. That would be a blow to Colombia. Despite a long civil conflict and well chronicled lawlessness, this country prides itself on fiscal rectitude. In sharp contrast to most Latin American nations, Colombia has not defaulted on its debt since the 1930's. Unlike Brazil and Argentina, already deemed junk for issuance of sovereign debt, Colombia has enjoyed investment grade status since 2011.

Before the pandemic, Colombia boasted the fastest growing of the region's major economies. GDP expanded by 3.4% in 2019 and the fiscal deficit was on a downward trajectory. The country's debt stood at around 45% of GDP. The pandemic has been punishing. One in every 23 Colombians has had

Covid-19 according to official figures, and the true number is probably higher. Nearly 60,000 people have died. The economy contracted by 6.8% last year – the worst fall on record- and debt soared to above 60% of GDP. The fiscal deficit has ballooned to 9% as the government imposed strict lockdowns and announced measures to help businesses and the poor.

The upshot is that President Duque has few alternatives but to raise revenue. The government is aiming for a reform worth at least 1.5% of GDP, or $4.4 billion, and will try to trim Colombia's vast web of tax exemptions, which cost the state roughly $20 billion a year. Most of those exemptions are on payments of value added tax, which is set at 19%. By scrapping even some of them, the government could raise the revenue it needs. But politically it will be tough. In 2018, the government tried to abolish VAT exemptions on some basic foodstuff. The plan caused an uproar: it was seen as a tax on the poor and congress watered down the reform package to such an extent that it was revenue neutral.

The political scenario is no more auspicious now than it was then. Duque's rightwing Democratic Center party has fewer than 20% of the seats in congress and needs the support of other parties. Some have already indicated they will not consent to a repeat of the 2018 proposals.

A rating downgrade would certainly cause capital outflows; and would likely lead to higher borrowing costs. Fitch has warned that a downgrade would have knock-on effects and would negatively affect some corporate, bank and infrastructure ratings. Fitch affirmed that eight of the 21 Colombian companies that it rates would be downgraded along with the sovereign. Furthermore, President Duque will not want to go down in history as the president who steered Colombia to junk status.

Close collaboration between Colombia and the U.S. is expected to continue under the Biden administration. Although the bilateral relationship will continue to revolve around issues such as the fight against drug-trafficking and strengthening bilateral trade, there will be new areas of focus as well. In particular, the implementation of the peace agreement with former FARC guerrillas, and providing help with millions of Venezuelan migrants who fled economic hardship in their country and now reside in Colombia.

The trade relationship is also expected to grow stronger. The U.S. will encourage nearshoring production of U.S. firms by redirecting U.S. supply chains away from Asia and toward Colombia, Mexico, and Central America. In order to promote investing in Colombia, the U.S. is expected to maintain the Colombia Growth Initiative, which intends to bring $5 billion in private investment over 2021-23, and to facilitate credit from the Development Finance Corporation and other U.S. state agencies.

Notwithstanding President Duque's favored relationship with the previous Trump administration, it appears that President Biden is intent on forming a positive working relationship with Mr. Duque.

Brazil

President Bolsonaro ousted the head of state-controlled oil major Petrobras after he refused to cap fuel prices. The move sent Brazilian markets in a tailspin as foreign investors rushed for the door, pulling billions of dollars out of the country amid fears that Brazil was returning to the days of government intervention in its big state-controlled companies.

Tens of thousands of truck drivers across Brazil had been gearing up for a strike over rising gas prices, poor roadways and corruption that has long plagued Latin America's largest nation. Mr. Bolsonaro's move was welcomed by many truckers, who complain that the cost of fuel combined with falling freight prices have made their livelihoods unsustainable. Their complaints carry weight: Brazil has long been dependent on truckers to keep its economy moving. More than 60% of cargo in this continent-sized nation is trans-

ported by trucks, compared with 32% in the U.S. and 43% in Canada. Excluding iron ore which is usually moved by rail – and that figure increases.

When truckers staged their last strike in 2018, the Brazilian economy ground to a halt as food and fuel supplies ran short and offices were forced to close. The 10-day strike shaved as much as 1.2 percentage points off growth that year. Truckers opine that conditions are worse today than back in 2018 in terms of prices, but they applaud having the president's ear and a dialogue with the government this time around. In 2018 the truckers had no such accommodation according to an industry lobby group, the Brazilian Association of Motor Vehicles. The strike and the government's response showed that the truckers were a priority for the public, and with the pandemic they are even more crucial. The transport sector is working on shipping vaccines and is considered on the front lines along with nurses and medical personnel.

The country's reliance on truck drivers goes back to the mid-20th century when the country adopted wholesale the road and car culture of the U.S. Road projects have also provided useful cover for corruption, with construction companies massively inflating their costs and giving kickbacks to the state and local politicians who granted approval – all at the expense of the taxpayer.

Today much of Brazil's road network is in poor condition, increasing the cost of transportation and damping investor appetite to purchase concessions to operate the highways. The problems are particularly acute in interior states [such as Mato Grasso and Mato Grasso do Sul] which have emerged as agricultural powerhouses.

While agribusiness is an increasingly dominant driver of the Brazilian economy, it remains hamstrung by the costs of moving product thousands of miles along bad roads to coastal ports. Truckers complain that they are squeezed between the falling wages offered by transport companies that contract them and the rising costs of diesel fuel which has increased by 30% in the past year.

Since coming to power President Bolsonaro has attempted to address the issue of poor or inadequate highways, focusing heavily of improving the road network in Brazil's vast interior. In 2020 the government succeeded in paving the final stretch of the main highway – which bisects Brazil north to south – opening up a new route to move soybeans out of states such as Mato Grasso. The government gets high marks on trying to solve these problems. The ministry of infrastructure is also pursuing new railway projects that is aimed at crisscrossing the country, but politics is standing in the way.

The government has also placed a temporary freeze on some fuel taxes and considered a special stipend for truckers, although the stipend plan appears to have been suspended after the upheaval at Petrobras. Separately, president Bolsonaro recently announced new proposals to facilitate the privatization of two state-owned companies: the postal service, and Electrobras, the state-owned electric utility. This latest move is viewed as a signal by the president to markets that his administration is still committed to liberal reforms. Overall, there is little of expectation that there will be much movement on the privatization agenda in 2021-22, owing to weak support in congress. The privatization of Electrobras promises to be especially challenging and would take years.

President Bolsonaro is prioritizing his re-election campaign in 2022 and his commitment to the reform agenda will continue to fluctuate in the face of political pressures. This will cause market volatility to remain high this year; and will likely lead to an earlier start of a tightening cycle in monetary policy. This is in consideration of rising inflation pressures (amid rising oil prices) and a weaker Real.

Meanwhile, Brazil's labor market is slowly recovering.

Recent data show that many workers returning to the labor force found jobs as the economy reopened. However, the outlook was clouded by a second wave of Covid-19 infections and the tightening of restrictions in movement, which will reduce demand for labor and hurt job creation, mainly in the services sector. Overall, a weak labor market will dampen consumer demand and therefore restrict the speed of the economic recovery. GDP growth is projected to grow by 3.2% in 2021.

EL Salvador

Elections held on February 28 provided a landslide victory to El Salvador's sitting president Nayib Bukele. The populist president will become the country's most powerful leader in decades, with his allies winning control of parliament and removing the main check to his authoritarian government.

The results will be awkward for the U.S. administration which voiced worries over Bukele's tactics. These included his disobeying El Salvador's supreme court Covid-19 quarantine rules, and sending troops into the national assembly to coerce legislators into approving his spending plans. The President's New Idea's party and its allies now controls more than 60% of seats in the new parliament and the landslide results gives Bukele the power to nominate supreme court justices. His harsh crackdown on crime, gang violence and his adept social media campaigns against corruption and traditional politics have made him popular with Salvadoreans who are tired of endemic violence in their country.

Voters turned decisively against the two traditional political parties that have dominated successive governments since the end of El Salvador's civil war in 1992. These are, the leftist FMLN and the right-wing ARENA grouping. Between them, the two parties won less than a quarter of the votes in this election. The extreme concentration of power in the hands of the 39 year-old populist will be a test for El Salvador's young democracy. Yet, to some observers the electorate has granted Bukele an unparalleled opportunity to approve necessary, urgent structural and socio-economic reforms.

Bukele is expected to use his new parliamentary majority to push ahead with borrowing plans, including a request for an IMF program to underpin El Salvador's shaky finances. The fiscal deficit hit 9.6% of GDP in 2020, and the country's debt continues to balloon. Moody's Investors Services calculates that borrowing will surpass 90% of GDP in 2021-22. Concerns over the sustainability of the country's debt build-up have sparked a sharp deterioration in market sentiment towards El Salvador, which needs to maintain market access as it must repay $800 million in loans in January 2023.

The economy will recover slowly following the 9.3% pandemic-induced contraction recorded in 2020. External demand is expected to be the main driver of any recovery over the next few quarters. High unemployment is expected to weigh on the pace of the recovery, while GDP growth is projected at 3.9% in 2021. A return of GDP to pre-pandemic levels is not expected until 2023.

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