Major Country Risk Developments

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Overview

Inflation in the advanced economies hit a 30-year high, pointing to a squeeze on household living standards and to increasing pressure on central banks to raise interest rates. The annual pace of consumer price growth in the OECD group of developed countries reached 6.6% in December. That's up from 1.2% in the same month the previous year and the highest since 1991.

Energy continues to be the main driver of high inflation across the OECD, with an annual rate increase of 25.6%, despite being marginally down from November's reading. The dip was more than offset by accelerating food prices growth, which hit 6.8% in December - more than double the rate in the same month last year. Prices grew across most items and is also geographically broad, rising well above the central banks' target of 2% in the U.S., Canada, UK, Germany, Italy and France. National data showed that inflation has accelerated further in the eurozone and the U.S. in January.

USA

The U.S. economy rebounded strongly in 2021 [GDP 6%] but slowed as the Omicron variant hit in December. Employment picked up pace in January with the economy adding 467,000 jobs for the month, far exceeding expectations. Job growth figures for November and December were also revised upwards – providing evidence of a resilient recovery. Government bond yields surged worldwide after the strong U.S. jobs report.

Investors' expectations that central banks will begin steadily raising interest rates to fight inflation have been boosted. Strong demand for goods coupled with disruptions to supplies have fueled inflation, sending it to a 39-year high of 7% in December. Manufacturers struggled through material shortages, transportation bottlenecks and workers quitting or calling in sick when Omicron cases surged across the country. The Institute for Supply Management's monthly index fell to 57.6 from 58.8 in December.

Prices for goods such as furniture, appliances, cars, and energy are up as much 20%-40% over the last year. Meanwhile services inflation, including rent and airfares also increased, albeit more moderately than auto prices. If consumer spending rotates back to services from goods, some of the upward pricing pressure of goods may begin to fall. However, there is no evidence pointing to a fall from current inflation highs anytime soon.

The labor market remains tight with job openings and worker- turnover hovering near the highest levels on record. Job openings were up slightly at 10.9 million [from 10.8 million the prior month]. The number of job openings continue to far exceed the number of available workers. Economic activity has picked up pace once again, as Omicron's impact recedes. Restrictions on remote work are being modified to more flexible options. While remote learning continues, in-person school/college classrooms reopen. The economy appears to be readjusting to a new normal. While the future of Covid-19 remains uncertain, there is a growing consensus that populations will learn to live with the virus, which may require annual vaccines going forward.

Separately, longer-term challenges facing the U.S. economy include being better prepared for future shocks, epidemics; and being more globally competitive. Investing, embracing and applying new technologies

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across sectors, reshaping supply-chain platforms to become more resilient are high on the list of priorities. Training, education and preparing the workforce for a post-pandemic economy will be driven by next-generation technology readiness. Investment in Bio Science, AI, EV, Robotics, Biomedicine, alternative energy sources – are all key to ensure future U.S. competitiveness.

The Federal Reserve has confirmed that interest rates will begin to rise in March 2022- a move that was long anticipated. At least three rate increases are expected over the course of 2022. The Fed needs to maintain a delicate balancing act, given ongoing strong demand, surging prices, supply-chain weaknesses, labor and material shortages – all converging at the same time. Policy changes in the current environment affect business, consumer and market confidence in different ways.

At several locations across the U.S., there is little to no commercial warehouse space available to stockpile goods as a hedge against supply chain problems. Some firms are reportedly signing deals for additional space storage long before new construction begins. Meanwhile, recent data shows demand for workers and the numbers quitting their jobs remain at historically high levels. The rethinking of traditional attitudes to work and learning - is now a critical global challenge for employers, workers, labor unions, banks, companies and policymakers alike.

Eurozone

Eurozone inflation increased to a record 5.1% in January as steep increases in energy and food costs defied expectations of slowing price growth. This adds increasing pressure on the European Central Bank (ECB) to respond with tighter monetary policy. The ECB now indicates that it too will be taking steps to begin raising rates and end its monthly asset purchase scheme in the months ahead.

Eurozone energy prices rose by a record 28.6% from the previous year in January. Soaring energy and food prices are squeezing household budgets. A quarter of German consumers say they'll struggle to make ends meet in 2022 because of higher prices. The rising cost of living will likely dominate the first ECB governing council meeting in February – even as the bank sticks to its timetable for keeping interest rates unchanged until it gradually reduces asset purchases over the course of this year. Some believe this approach may be too slow.

Economists expect European wage growth to pick up after the eurozone unemployment rate hit an all time low of 7% in December, with youth unemployment also at an all-time low of 14.9%. While businesses are increasing pay, perks, and training to try to address the problem, workers are flexing their muscles for higher pay and better conditions. A quarter of EU companies report labor shortages are at new highs. The persistence of inflation above the ECB's 2% target has already caused widening divisions on the ECB governing council. The heads of the German, Belgian and Austrian central banks complained last month that the ECB was committing to continue bond purchases for too long and urged the consideration of interest rate increases.

German business confidence fell for six consecutive months. This raises fears that Europe's largest economy may be heading toward a recession. New data shows activity in the eurozone's services sector slowed recently due to renewed pandemic restrictions. However, there are signs of an easing in manufacturing supply-chain problems.

Policymakers at the **Bank of England** (BOE) fear a wage-price spiral of workers demanding raises because of higher living costs, while companies raise prices to

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protect their margins in a repeating, self-fulfilling process. The BOE raised interest rates for the second time in two months, hoping to get a grip on soaring inflation of 7%. The rise in interest rates alongside the highest rate of inflation in 30 years will squeeze household incomes by reducing spending power by approximately 2% says the BOE.

Meanwhile, supply chain troubles around the globe drag on. The havoc at ports shows few signs of abating, driving home the realization that time alone is unlikely to solve the great supply chain disruption. Doing so will require investment, technology updates and refashioning incentives at play in global business. The effort will require more ships, additional warehouses, and an influx of truck drivers – none of which can be conjured quickly or cheaply.

Cheap or reliable shipping can no longer be taken as a given, forcing manufacturers to move production closer to customers. The shortages have companies across various industries warning of more delays or impacts to profits. The IMF cited supply chain woes as a factor as it downgraded its forecast for 2022 global growth to 4.4% from 4.9%. Mayhem at ports and shipping yards, combined with the market dominance of major companies, is a key driver for rising prices.

Peru

Pedro Castillo, Peru's embattled new president, has reshuffled his cabinet for the third time during his first six months in office. A former primary school teacher turned activist, with no prior political experience, Castillo was elected and sworn in July 2021. In February 2022 his prime minister, finance minister and interior minister quit the government, charging that the president lacks leadership and has done little to address corruption in his administration. The president must now submit his newly reshuffled cabinet to the opposition-controlled congress for a vote of confidence. He will likely have the support of Free Peru, the Marxist party that propelled him to power last year and is the largest party in congress with 32 of the 130 seats. Other parties have not yet made their positions known. Ultimately, there is a reasonable chance that legislators will acquiesce and give the president the votes he needs, even if they dislike his choice of ministers.

Castillo's central platform is that mining interests in Peru's lucrative oil and minerals sector do not pay enough taxes. Mining is the lifeblood of the Peruvian economy. The mining companies, mostly multinationals, retort is that they pay billions in taxes each year and insist that the real issue is the misuse of those funds by government.

After two decades of relative stability, there has been a reversal with four changes of governments over six years between 2016-21.

The new government has been plagued by chaos, resignations and scandals almost from the beginning. In addition to over 20 ministerial changes in the last six months, Castillo has removed the head of the police force and clashed with senior military officers while numerous advisors have quit. The instability in leadership and lack of consensus have been a drag on the economy and weakened the currency, the sol. The disorder is further reason for loss of business confidence, especially since the private sector had been braced for policy disagreements but must first confront the government's dysfunction.

With four and a half years left in his tenure, President Castillo must first display a capacity to govern, or he could face impeachment or early elections. According to the most recent poll, as of January Castillo still had the support of a third of the country. However, the polling company now suspects that his rating has worsened

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since then. The president came to power with the appealing promise of “no more poor people in a rich country”. It was a message of hope for millions of Peru’s poor voters living in rural Andean communities, some of whom still regard Castillo as a good man trying to do a tough job. However, the consensus among analysts in Peru is that the upheaval in the government has stymied any attempt to bring about the social and economic changes that Castillo promised and Peru needs. The struggle now is no longer about ideology or the left versus right. Instead, it’s about different interest groups within government, some of whom are very small and some exhibiting corruption. Furthermore, there is lack of governance without someone coordinating the direction of the administration. Barring a dramatic event such as the president’s resignation, there appears to be no clear way out of the crisis. Even if Castillo were impeached, his vice-president would take over. While she might prove a more effective leader, she could struggle to garner support in Congress. In January she was expelled from Free Peru for criticizing its hardline Marxist leader.

In response, Castillo says he is the victim of a right-wing plot to oust him and that a powerful, conservative Lima-based elite has never given him a chance to govern. He recently addressed the nation and urged legislators to consider more than 20 pieces of draft law his administration has sent to congress in recent months.

One silver lining was the recent appointment of Oscar Graham as the new finance minister. He is regarded as a technocrat with years of experience at both the Finance Ministry and the central bank. Business leaders are looking to this appointment as one source of stability which could help ensure that the post-pandemic recovery remains on track.

Peru’s business environment is expected to remain relatively stable in 2022, with economic growth offsetting the weaker political environment. Meanwhile, the country’s openness to foreign trade is secured by multiple free-trade agreements.

Chile

President Gabriel Boric a former student protest leader was elected President of Chile in December, beginning a decisive shift to the left in Chile -after several years of civil unrest. The 35-year-old president will take office in March, having no prior experience in public office. Despite promising unity after a bitter contest between extremes of the political spectrum, the outlook for his presidency is uncertain.

Boric surfaced a decade ago during street protests against inequality in education and is the first leader to come from outside the centrist political mainstream that has largely ruled Chile since its return to democracy in 1990. President-elect Boric, part of a broad leftwing coalition that includes the Chilean Communist party, is opposed to mining initiatives that the candidate claims are harmful to the environment. That includes the contentious $2.5bn Dominga mining project that was approved last year. The new president has pledged to enact higher taxes, greater public spending, scrapping of private pension schemes and student debt, as well as other reforms intended to empower women, indigenous groups and minorities. Congress, however, will prove a big obstacle to his reforms. The lower house was practically tied after November’s general election.

There are 21 different parties in the lower house and many parliamentarians are not beholden to Boric’s party. Other stiff challenges for the new government include redrafting of a constitution to replace the deeply divisive text adopted in 1980 during the Pinochet right-wing regime. To his critics, Boric is a radical who lacks experience. His opponents fear he could try to build an authoritarian socialist state in Latin America, akin to that of Venezuela. Boric has described himself as a moderate

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but previously said he wanted to bury the country's "neoliberal" past of market-oriented policies that have failed to narrow social divisions.

Demonstrations which began two and half years ago alarmed Chileans used to decades of order and stability. The initial unrest, triggered by metro fare increases, gave rise to a long list of public demands over income inequality and high living costs. With the election, Chileans changed the forces that ruled the country for three decades, shifting power away from traditional elites to a younger, more radical generation.

Foreign policy under the new government will remain broadly open to trade and foreign investment, although the policy platform indicates a desire to renegotiate Chile's free trade agreements (FTA's) to support the president's progressive social and economic agenda. Still, Chile's FTA access to over 80% of global GDP (including the U.S., China and the EU/UK)- will support the business environment.

There remains a high degree of uncertainty regarding the policy landscape over the next four years – owing to the scope of the government's reforms and the likely legislative challenges that it will face in passing them. A further source of uncertainty is the ongoing constitutional reform process (rewriting the constitution).

The forecast is for economic growth to slow to 3% in 2022, after an estimated 11.8% expansion in 2021. The slowdown in the pace of growth reflects a fall in pent-up consumer demand, as emergency stimulus schemes are wound down; and monetary tightening. In addition, concerns about the potential deterioration of the business environment under the new president and uncertainty regarding the policy landscape under a new constitution (which is expected to be ratified by end-2022) will weigh on business confidence and investment.

China's economic slowdown is being watched, as the country is Chile's main trading partner and export destination.

The announcement that the president of the central bank will serve as Mr. Boric's finance minister suggests that the government will remain broadly committed to pragmatic fiscal and monetary policies. Despite this continuity, economic policy will likely involve an expansion of the state's role in the economy, signifying a shift away from Chile's decades-long commitment to free-market policies. This assumes that public demands for increased focus on state provision of social services, as well as populist policymaking over the past year, will encourage Congress to pass reforms that expand the state's role in the economy.

Inflation is forecast to remain elevated during the first half of 2022, as domestic demand remains high against a backdrop of expansionary fiscal policy and pension withdrawals in 2021; high commodity prices; global supply-chain bottlenecks; and peso depreciation caused by policy and political uncertainty. During the second-half of 2022 inflation is expected to decline as demand eases, supply chains normalize, and the central bank's monetary-tightening cycle comes into effect. This is forecast to bring inflation to 4.2% at year-end 2022 from 7.2% at end-2021.

The nature of the political landscape during the new government's term (which ends in 2026) will be dictated by two main factors: the outcome of a constitutional reform process that began in 2021 and will be put to a referendum later this year; and an evenly split Congress that will force Mr. Boric to pivot to the center in order to pass legislation. The next important vote is a mandatory referendum to either approve or reject the new constitution, which is currently being drafted by a constituent assembly. The vote is due to be held in the second half of this year, probably in September. However, given the slow progress in drafting the new

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text (no reforms have been voted on so far), there is a heightened risk that the exit referendum could be delayed until end-2022 or early 2023. Expectations are for the constitution to be approved. The next presidential and legislative elections are not due until November 2025.

Chile has the region's strongest macroeconomic framework and independent institutions, including the judiciary and central bank and continues to be the best rated country in Latin America. We expect some of these institutional advantages to be retained over 2022-26, even while the business environment will likely become less predictable. Local bankers and businesspeople are watching the situation cautiously. The consensus is that a certain level of pragmatism will likely prevail in the Boric administration's approach to the private sector and foreign investors. Only time will tell if this is too optimistic an outlook.

Brazil

A surge in foreign capital is boosting markets in Brazil, as foreign investors seek to take advantage of double-digit interest rates, cheap assets, and growing confidence in the longer term political stability of Latin America's largest economy.

In January, offshore investors bought more than $6 billion in local stocks according to the latest data – the second largest monthly inflow since 2008. The uptick in optimism comes despite the potential turbulence of presidential election due later this year.

The pandemic has killed around 700,000 people in Brazil and government cash handouts have ended. With that President Bolsonaro's approval rating fell from 37% to 23%. While the government has attempted to make the case that 50% of Brazil's covid deaths in 2020 were due to other causes, few Brazilians accept that explanation. The sitting government has gone to great lengths to manipulate data (or simply not make them available) probably to obscure the facts surrounding the country's recent economic performance.

The upcoming presidential election will see former president Luiz Lula da Silva face off against Mr. Bolsonaro – a contest that so far has no clear favorite among the local business class. However, recent polls show Lula as the dominant figure among the overall electorate (in some polls Lula enjoys a 20 percentage point lead although the gap appear to be narrowing]. Foreign investors perceive that Brazil under Lula stands a good chance of flourishing once again. The narrative is that foreigners recall that during Lula's two terms between 2003-2010, Brazil experienced growth, wealth, and booming markets. Meanwhile, to many locals that period is perceived as being linked to corruption scandals. Some foreign investors apparently are betting that Lula will likely emerge with more political support than the incumbent.

The economy suffered a recession between 2014-16 which strained budgets. Brazil struggled to recover even before the pandemic hit, which caused a deep economic plunge once again. In 2021 GDP grew by 2.5% and is projected to grow 3% in 2021.

The Brazilian main stock market fell 12% in 2021, leaving assets highly discounted. Early in February, the benchmark Bovespa share index reached its highest level since October, while the currency, the real, hit 5.25 per U.S. dollar. The Bovespa has added 6.6% since January, compared with a 5.6% decline for the MSCI World Index (priced in dollars).

Meanwhile, the central bank raised interest rates on February 2, 2022 to 10.75% - the first time rates have hit double digits in five years – as the country struggles to

tamp down surging inflation [currently at 10.5%]. The central bank has raised its rate eight consecutive times by 8.75 percentage points since March 2021. Most of the inflow of funds into Brazilian stocks have gone to liquid, large companies, many linked to commodities. The main attraction being attractive asset prices and a tightening monetary cycle.

Looking ahead to the winding down of the pandemic and the potential for a new administration, there are signs of optimism among local businesses and consumers alike. Job openings have increased, and some companies complain of having trouble hiring qualified workers to fill openings. The worker shortage was partly due to the spike in Covid cases in December-January when manufacturers reported a drop in production (output of vehicles were down 27.4% in January) while staff were out on medical leave.

Meanwhile, some Brazilian analysts warn against underestimating the risks that Brazil faces from a potentially polarizing and tumultuous election cycle. We should expect a period of volatility in the run-up to the November elections.

Argentina

Negotiations between Argentina and the International Monetary Fund for much needed debt restructuring produced a blueprint that could eventually lead to an agreement that requires the approval of the IMF's Board of Directors. The initial agreement is to restructure $44.5 billion of Argentine debt owed to the IMF. Without an agreement Argentina will need to make a payment $2.8 billion on its debt in March.

More detail needs to be worked out before the blueprint is agreed to by both parties, the IMF signs off and this becomes an actual agreement. Already, there are disagreements and resistance to the blueprint within the ruling Peronists in Argentina's government.

Meanwhile, Argentina's largest oil union began an indefinite strike to press its demand for a wage hike to make up for loss of purchasing power due to high inflation (currently above 54% per annum). The strike was called by the Private Oil and Gas Union which represents 24,000 workers in three oil producing provinces. The strike could impact activity at oil firms operating in Argentina's main shale formation – the world's fourth-largest unconventional oil reserve located in Argentina's Patagonian region.

As workers walked off their jobs, the companies asked Argentina's Ministry of Labor to intervene by calling for a mandatory conciliation to prevent the conflict from spreading. The companies are trying to keep the oil processing plants running but drilling has stopped. Unions in Argentina have long sought to rebuild the purchasing power of workers, who have been hammered by long-running high inflation.

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