Major Country Risk Developments November 2021

By Byron Shoulton

Overview

The economic recovery is continuing with global growth projected at 5.9% in 2021 and 5% in 2022. This is being led by the U.S., China, and Europe. Strong near-term prospects among some commodity-exporting emerging markets and developing economies are also noteworthy as global demand drives activity in mining, minerals, and the need for wide varieties of raw material supplies from many countries. Countries are recovering at different speeds and central banks are displaying varying levels of discomfort with inflationary spikes. Policy in the U.S. is especially important given the pivotal role of the dollar: 88% of over-the-counter foreign exchange trades involve the greenback, according to the Bank of International Settlements.

The U.S. Federal Reserve took its first step toward slowly withdrawing some of its extraordinary monetary support from the economy. The Fed announced that it will slow bond purchases in a step toward pursing more normal monetary policies and begin winding down stimulus programs which have been in place since early in the pandemic. As the economy appears to heal, the Fed is becoming increasingly hawkish and appears set to consider beginning to raise its policy interest rate in the second-half 2022 (or earlier if officials deem that conditions require it). The Fed is concerned with high inflation at a time when millions of workers remain on the sidelines of the U.S. labor market. Millions of others retired during the pandemic.

With booming consumer demand, prices are climbing [across the board] at an uncomfortably rapid pace. Many industries face prolonged shortages of raw materials, components and workers, and policymakers have grown wary about inflation expectations. They are not sure when prices will begin to calm down and how quickly the labor market will recover the millions of jobs missing since the 2020 economic slump. Meanwhile, U.S. interest rates remain at rock bottom to keep borrowing and spending cheap and easy – for the time being.

The U.S. central bank's decision to dial back its other policy tool, large-scale bond purchases that keep money flowing through financial markets, is meant to give the Fed flexibility at a time when the economy's trajectory remains uncertain. Fed officials have laid out a plan to slow the $120 billion in monthly Treasury bond and mortgage-backed security purchases by $15 billion a month starting in November 2021. The purchases can lower long term interest rates and prod investors into investments that would spur growth.

The Fed is not yet saying that higher interest rates, a powerful tool that can swiftly slow demand and work to offset inflation, are imminent. Policymakers prefer to leave rates low for some time to allow the labor market to heal as much as possible. The recent Fed move leaves the central bank more nimble to react if inflation remains sharply elevated into 2022 instead of beginning to moderate. Twenty months into the global Covid-19 pandemic, U.S. inflation has shot higher, with prices climbing 4.4% in the year through September. That is well above the 2% price gains the Fed aims for on average over time. Officials have been caught off guard by how much inflation has surged and how long that uptick has lasted. Economists expected some run-up in prices as the cost of dining out and air travel bounced back from pandemic lockdown lows, but the severity of supply-chain disruptions and the continued strength of consumer demand has been a surprise.

October's U.S. jobs report exceeded expectations as payrolls jumped 604,000 and the unemployment rate fell to 4.6% from 4.8%. Growth was especially strong in leisure and hospitality, manufacturing, transportation, construction, and healthcare. More people are returning to work as pandemic cases subside, government unemployment programs expire, vaccines are delivered to over 70% of adults, and restrictions are being relaxed. The U.S. jobs market remains tight, and employers are raising wages to attract workers. Many employers report they cannot find sufficient and qualified workers.

About 4.2 million workers are missing from the U.S. economy compared to February 2020. That shortfall is hard to interpret, because businesses across the country are struggling to fill open positions and wages are quickly rising. Meanwhile, U.S. workers filing for unemployment benefits continue a steady downward trend, approaching levels last seen before the pandemic. If October's positive job results continue to hold over the coming quarters, that will be a sure sign that the post-Covid recovery is at hand.

Earlier expectations that elevated inflationary pressures would be transitory have been replaced with the likelihood that inflation could become erratic in the months ahead. If that were to persist it would make it harder for businesses to plan; and would eat away at wage increases for workers who lack bargaining power.

Meanwhile, the U.S. trade deficit has widened, driven by climbing demand for capital goods like computers and electronic equipment and industrial supplies that have been soaring in cost as global supply chains remain overwhelmed and badly snarled. The trade deficit is being driven wider by shifting patterns of demand for raw materials and inputs for U.S. factories and retailers, which are precisely where supply chains have been clogged and where imported inflation has been running rampant.

After collapsing during the early days of the pandemic, global trade has soared back in 2021, repeatedly pushing the U.S. trade deficit to record levels. Earlier this year, it was a resurgent U.S. consumer, bolstered by multiple rounds of government stimulus, that helped drive demand for imports. That dynamic has shifted in recent months, as imports of consumer goods have sagged – falling in most months since hitting a peak in March and dropping again slightly in September. The value of apparel imports for example fell 2.1% in the first nine months of 2021, compared with the same period in 2020. By contrast, U.S. demand for industrial supplies and fuels has surged. The value of imports of iron and steel was up 93% in the first nine months of 2021 compared with the same period in 2020. Wood imports rose 79% while copper rose 82%. That has driven prices higher and led to more imports of those goods and fewer exports. Over the past year, imports of industrial supplies have risen by 56%.

Prices have been further driven up by economies that are out of sync. While the U.S. economy has been gradually opening, with businesses ramping up activity, many of their suppliers in Asia entered renewed lockdowns this fall. Many factories in Asia are unable to fill orders due to lack of available inputs, insufficient workers, or plant closures. Transportation bottlenecks globally, millions of containers on ships awaiting final port delivery; lack of storage facilities, trucking and driver shortages, and worldwide energy and raw material shortages are driving up costs, adding to frustration and continued uncertainty.

Europe

The European Central Bank (ECB) will decide in December how to gradually phase out its $2.54 trillion pandemic emergency purchase program. It is expected that the bank will maintain a dovish stance and that the tapering of quantitative easing will be slow.

A shortage of semiconductors has hit Europe's manufacturers hard. Nowhere more so than the region's economic engine, Germany, where automakers

contribute sizeable chunks to GDP growth. The latest official figures show **German** manufacturing output fell 4% with production of motor vehicles and trailers slumping almost a fifth because of supply chain woes. The shortage has also underscored the degree to which the rest of the world relies on Taiwanese foundries for crucial microchips. Taiwanese ongoing vulnerability to Chinese takeover is enough to sharpen awareness that this is not the most stable or predictable location on which to remain over-reliant for crucial technology supplies.

Recently, The European Commission proposed a European Chips Act, arguing that reshoring production of semiconductors, the majority of which are manufactured in Asia, was a matter of "tech sovereignty".

Separately, the reopening of the **Portuguese** economy, supported by the rollout of the vaccination program as well as the launch of the EU Digital Covid Certificate across Europe, should help drive solid growth in the number of visitors to Portugal in the remainder of 2021 and in 2022. Tourism performance has started to recover in 2021. However, comparisons with 2019 suggest that a return to pre-pandemic level of activity is unlikely before 2023. The recovery of tourism is in contrast to lagging in other sectors, dampening overall growth. GDP growth is projected at 4.1% in 2021 and 5.1% in 2022.

In **Spain** the public debt/GDP ratio is the fourth highest in the eurozone (after Greece, Italy, and Portugal). The government rejects a return to fiscal austerity until a full economic recovery materializes in late 2022. Ultra-low interest rates will minimize financial risks in the meanwhile.

The implementation of potentially market-unfriendly reforms such as the rollback of the 2012 labor reform and a controversial housing bill which could introduce caps on rent hikes, might worsen the business environment in 2022. In mid-October the Spanish government unveiled its 2022 budget – which it described as the largest public spending effort in the country's history. It focuses on social policies and includes record investment of over $55 billion, including $36 billion from the EU recovery fund.

Spain's unemployment rate declined to 15.26% in the third quarter of 2021 from 16%, amid easing of Covid-19 related restrictions. Labor market conditions have gradually improved in recent months helping to lift private consumption, estimated to have grown by 6.9% in full-year 2021.

Italy's solid economic performance in the third quarter of 2021 was moderately stronger than expected. The steady rebound reflects the positive impact on confidence and activity with the reopening of the economy, a better than expected tourist season and an improvement in the pandemic situation over the summer months. This was helped by a marked acceleration in the rollout of Italy's vaccination program following the introduction of mandatory vaccine passports to allow access to restaurants and public places in early August.

The industrial sector has so far proved to be relatively resilient to ongoing global supply-chain disruptions, but raw materials shortages and higher input costs will likely push manufacturers to cut production in the coming months. Meanwhile, the recent surge in energy prices in Europe will also weigh on manufacturing activity and private consumption. The government has responded by providing $5 billion worth of support to counter rising energy costs for consumers and businesses. Nonetheless, a hit to consumers and businesses is inevitable. The full-year real GDP growth estimate for 2021 is estimated at 6.3%. Forecast for 2022 GDP growth is 5%.

As western Europe heads into the winter months, Covid infections are on the rise across the continent. The good news is the fatality rate is a fraction of what it was at its peak. One-third of new cases are among school-age children.

The **UK** is still an outlier, with daily new cases higher than most other countries in Europe. Cases are rising

in Belgium, Austria, and the Netherlands, suggesting they could reach levels similar to the UK soon.

Still, high vaccination rates will enable countries to avoid imposing full lockdowns. For example, under a step-by-step plan introduced in September in Austria, restrictions will be imposed automatically when specific levels of occupancy are reached on intensive care wards.

A winter spike in Covid cases will dampen the recovery in the services sector as consumers continue to act with caution and maintain high levels of savings. This, combined with the ongoing energy crisis (which will hurt disposable incomes), means that consumer spending will remain subdued until mid-2022 earliest.

Countries that have traditionally been more fiscally conservative, including Denmark, Austria, Sweden, and the Netherlands, are all targeting moderate-sized deficits in 2022. Other economies, including France, Spain, and Italy, are planning much higher deficits of about 5% of GDP.

Energy shortages

Record U.S. liquefied natural gas [LNG] exports to China contrast with just a few years ago during the trade war between both countries. At the height of the trade war in 2019, China cut off imports of U.S. LNG. Today, China is buying more gas from the U.S. than it ever did.

The turnaround is one consequence of the ongoing global energy shortage that has sent prices soaring. It also reflects China's effort to cut carbon emissions by reducing how much coal it burns. The energy shortage, China's most severe in many years, has forced the government to curtail operating hours at factories and cut power in some cities. The shortage is due to factors including stronger-than-expected demand for factory exports as the global economy rebounds from the pandemic, increased movement toward gas from coal to fight pollution and a lack of rain in parts of China that has hindered its hydroelectric supply.

LNG prices have soared in response [up ten times where they were at this time last year before a recent fall]. China's natural gas needs are already huge and growing steadily as it pledges to cut demand for coal and seeks to hit a peak of carbon emissions by 2030. China is likely to overtake Japan this year as the world's biggest importer of LNG. Natural gas accounted for around 8% of China's total energy needs in 2020, up from 3% in 2009. The country is under increased pressure to reduce its greenhouse gas emissions faster. Perhaps more than for any other country, the current energy shortages have complicated China's promises to gradually move away from fossil fuels as it seeks to ensure stable energy supplies. China today accounts for 17% of total U.S. LNG exports. China's largest energy companies have been on a quest to secure more long-term supplies, which makes them less vulnerable to price swings on the spot market.

The energy shortages in China are part of a global story. Europe has also been forced to contend with rising prices driven by strong gas demand as the region rebounded from the pandemic. Energy consuming countries led by the U.S. are asking the world's crude producers for more supply to help drive down prices. Nonetheless, the Opec+ oil producer group led by Saudi Arabia and Russia rejected those pleas and stuck with a plan to add 400,000 barrels of crude a day of supply each month, gradually restoring the huge swath of production it agreed to cut last year to lift prices.

Oil prices, already above $80 per barrel, are at their highest in seven years. While soaring natural gas prices in Europe and Asia have sparked alarm, the oil rally is gathering momentum. Some believe the current spike could lift prices almost as high as 2008 when it hit $150 per barrel. Tightening climate policies will eventually overwhelm the industry. The next few years could still bring a bonanza for producers but could prove crippling for energy importing economies. Opec+ producers will reap the rewards of

higher prices, but consumers and importing countries will pay the price. Ultimately, concern over soaring fossil fuel prices will likely lead to a rethink of energy priorities, investment strategy and timing as far as renewables are concerned. The transition away from fossil fuels is inevitable.

Even now as cash pours in, oil groups mindful of courts, public sentiment, activist investors, and future revenue sources are balancing investments between crude production to satisfy shorter-term needs and investing in future alternative energy resources. Global energy security, costs and sourcing will dominate policy debates for the foreseeable future in both the public and private sectors.

Latin America

Headline inflation spiked in Latin America this year and expectations for 2022 suggest the trend will continue. An aggressive 125-basis-point policy interest rate rise in Chile in mid-October provided yet another signal that regional central banks are responding firmly to inflationary pressures, with a monetary-tightening cycle that is likely to endure for much of 2022.

Latin America, led by Brazil started raising rates earlier than its emerging-market [EM] peers. And although several EMs have followed the trend, such as Poland and Russia, Latin America's rate rises have as a group been more aggressive this year. The region's central banks have been looking ahead to the tightening of monetary policy in the U.S. in 2022, hoping to get a head start and avoiding another "taper tantrum". While there are no guarantees, it will help to prepare the ground for an orderly exit from an extremely accommodative U.S. monetary policy stance. This is important for Latin America because a pass-through from currency depreciation to consumer price inflation in 2022 could be higher than usual, as producers and retailers have already been forced to absorb huge rises in producer price inflation this year.

However, an aggressive tightening cycle carries risks. Higher interest rates will increase debt-servicing costs for the region's increasingly indebted public sector and place even more pressure on governments to tighten fiscal policy.

Apart from raising creditworthiness concerns and potentially placing some significant liquidity pressure on certain sovereigns, interest-rate rises will prompt sharper fiscal consolidation, dampening what has been a fairly robust economic recovery so far this year. For the first three quarters of 2021, economic activity in Latin America has in many cases returned to pre-pandemic levels.

The region's big challenge for 2022 is to produce a self-sustaining economic recovery able to withstand what are likely to be much tougher conditions next year. The consensus forecast assumes that GDP growth in the region will slow to 2.6% in 2022. Although the slowest pace of any region of the world, it does still assume some modest to moderate sequential growth over the course of the year. A new wave of asset sell-offs has placed fresh depreciation pressures on the region's currencies. Given an uncertain political and policy climate, it appears increasingly likely that Latin American currencies will undergo another stress test in 2022.

Early on in 2021 many regional currencies showed signs of stabilization and some, such as the Chilean peso, even recorded solid gains. However, in recent weeks all of the region's major currencies have succumbed to renewed depreciation pressures that have taken them back below pre-pandemic levels.

The current-account is not a cause for concern; most Latin American economies are reaping the benefits of roaring commodity prices and robust external demand. Instead, the main source of currency weakness is the financial account. This partly reflects weak foreign direct investment, which remains below pre-pandemic levels across most of the region. The most important factor at play is the exodus of portfo-

lio capital. The elevated level of political and policy uncertainty across the region has prompted foreign institutional investors to reduce their exposure to the region. Meanwhile, domestic companies, agents and investors are also dollarizing their portfolios to hedge against radical policy shifts. This is especially evident in **Peru**, where outward portfolio investment rocketed to an all-time high of $5.9 billion in the first half of 2021.

Political volatility in the region is unlikely to abate in the near term. Chile, Colombia, and Brazil all face general elections within the next 15 months, with left-wing candidates emerging as presidential front-runners in each of those countries. Additionally, ongoing constitutional reform in Chile, unstable institutional dynamics, and a leftist swing in Peru will all serve to dampen market sentiment and sustain the potential for more capital flight from the region in the year ahead. Even after taking into account the comfortable FX reserves position of many central banks in the region, risks are tilted towards increased currency weakening in 2022.

Colombia

Although the quality of economic policymaking will remain fairly high by regional comparison, economic performance remains subdued as Colombia recovers from the 2020 recession precipitated by the pandemic. Despite fiscal and monetary easing, real GDP contracted by 4% in 2020 and unemployment climbed. Economic activity began to rebound strongly in 2021 and is forecast to strengthen as the government rolls out vaccines and domestic demand recovers. Still, there will be little progress in the short-term on government pledges to structurally bolster growth and job creation, tackle widespread poverty and inequality, and improve industrial productivity. Renewed global demand appears the strongest likely stimulant to boost activity in Colombia's mining, minerals, and energy sectors over 2022-24, making them among the most fertile job creating sectors for the next few years.

Yet country operational risk remains. The president, Ivan Duque, will continue to focus on tackling the Covid-19 outbreak and restarting economic activity. A watered down tax reform, which will mostly eliminate tax exemptions, is expected to be approved in the coming months, but policy making will be hindered by upcoming general elections. Aside from the pandemic, other factors, such as security concerns stemming from internal conflict, drug trafficking and an influx of Venezuelan immigrants, will continue to hamper the operating environment.

Attacks on energy and transport infrastructure and kidnappings are common. Drug trafficking will remain challenging for the current and subsequent administrations, although overall political stability is not at risk. Separately, geographical challenges and poor transport infrastructure will continue to raise business costs. Urban and organized crime remains a problem, despite a falling homicide rate. Achieving long-term peace could still prove challenging as some former combatants in former guerilla conflict will continue to battle against government or join criminal bands, in addition to taking control of former FARC drug routes and territory. Abuses by the military against civilians is less of a problem these days, but recent corruption scandals have eroded trust.

Despite remaining security risks, the political system functions adequately and the mechanisms for transfer of power are well established. Governability under President Duque will remain affected by his minority position in the legislature.

Foreign trade and exchange policies are a top competitive advantage for Colombia. The country benefits from trade liberalization and capital mobility, based largely on its free-trade agreements, including those with Chile, Mexico, the Andean Community, the U.S., Canada, the European Free-Trade Association, among others. Closer integration to some Latin American countries under the Pacific Alliance, (comprising Colombia, Peru, Chile, and Mexico) is also moving ahead. Colombia joined the OECD in 2018, which will

enhance its policy environment and help attract investment inflows.

There is little danger of expropriation or confiscation of assets, and it is official policy in Colombia to encourage foreign investment by creating a clear, stable, and favorable regulatory framework.

Colombia's banking system remains sound, although monopolistic practices are common. Financial soundness indicators remain favorable. Regulatory changes and banking supervisory improvements in recent years have reduced credit risk, but bank holdings of government debt have increased. The local currency bond market is dominated by public-sector debt, leaving little room for corporate issues, other than those of local financial institutions. There are no capital controls on incoming or outgoing portfolio investments.

Colombia has among the highest effective tax burdens in the Americas for both corporations and individuals. A high level of distortion arises from differential rates and exemptions and frequent tax changes, complicating business planning. Despite a reduction in the number of payments and some simplification of procedures in recent years, many loopholes encourage evasion. The government has been aiming to close some of those loopholes and reverse the course on tax reforms implemented by the previous government in 2017, which included an increase in the value-added tax to 19% from 16%.

The workforce is generally perceived to be well educated and trained, but there are some shortages of highly skilled personnel. Fiscal constraints will undermine the government's efforts to narrow the skills gap. The overall quality of ground infrastructure is poor, reflecting the difficult terrain and previous shortages of investment. Electricity capacity is sufficient, but rising slowly, and therefore exposes the country to climatic changes like El Nino owing to dependence on hydroelectricity. Communications infrastructure is better, although the quality varies across the country. Despite improvements to some areas of physical infrastructure (including highways), roadway networks remain patchy and of poor quality. This combined with expensive toll roads and low availability of alternative means of transport, will keep transport costs high. Colombia fell by three places in the global ranking to 56th, despite an improvement in its overall score for 2022-26. GDP growth is forecast to gather pace over 2022-24, supported by a positive business environment.

Relations with the U.S. remain strong. Colombia is weighting its geographic advantage to benefit from expanding into alternative energy investments, including wind power.

Chile

Gabriel Boric the candidate of the far-left party is currently best placed to win November's presidential election. However, his policy agenda envisages contentious proposals- such as the introduction of mining royalties and wealth taxes- that could hurt the business environment and deter investment. Given Mr. Boric's consistent lead in the polls and the failure of moderates to gain momentum, the election forecast has been revised to reflect the expectation that Mr. Boric will be Chile's next president.

The peso will remain weaker than pre-pandemic levels in 2022. GDP growth is expected to stabilize in 2022 at 3.3%, after reaching an estimated 10.3% in 2021, when the economy recuperated all of its 2020 losses, making Chile among the first countries in the region to recover fully from the pandemic. Growth in 2022 will be driven by full economic reopening (as vaccine rollouts near completion), strong export growth, and continued fiscal spending (which will boost private and government consumption). Nonetheless, the ongoing constitutional reform process [the rewriting of the constitution], and pending presidential elections, will constrain the trajectory of real GDP growth in 2022-23. The effects of policy uncertainty stemming from political events will be felt more strongly over the medium-term. Fixed investment will

be particularly affected, growing by an annual average projected at 3.9% in 2023-26 (below pre-pandemic levels).

There is an underlying loss of confidence in the current system compared to that which Chile earned over the past three decades of economic stability. It will take time to regain that confidence. The assumption is that macroeconomic policy will remain prudent. However, the new constitution, which is expected to be ratified by mid-2022, is likely to include some populist reforms that will weigh on the business environment and investment going forward. This, along with rollbacks of fiscal stimulus and stabilization in external demand, will cause real GDP to moderate to around 2.4% over 2022-26.

The peso is likely to remain weaker than pre-pandemic levels. Since June 2021 the currency has lost 9% of its value against the dollar, driven by election jitters, concerns about labor strikes at major copper mines, and a generally tense domestic political-labor climate. Further currency depreciation is anticipated over the course of 2022, owing to asset sell-offs caused by uncertainty over election results, the exit referendum to ratify the new constitution (scheduled to take place second-half 2022), and ongoing labor pressures. Still, rising copper prices and monetary tightening should lend some support to the peso, preventing the undershooting of the currency observed during the peak of the pandemic in March-June 2020.

Annual consumer inflation rose for a third consecutive month to 5.3%, remaining above the upper limit of the 2-4% target range set by the central bank. Continued currency weakness and still strong demand-side pressures will keep inflation elevated in 2022-23. However, inflation should begin to decrease gradually in 2023.

Demand has been fueled by the reopening of the economy (enabled by the country's strong vaccination drive), expansive fiscal measures and successive pension withdrawals to the tune of almost $50 billion so far. Meanwhile, the currency has weakened since May. The currency depreciation has been driven largely by investor pessimism relating to the progress of a fourth pension withdrawal bill in Congress, the country's ongoing constitutional reform debate and the approaching presidential election.

Chile's current-account deficit is expected to widen over 2022-26, primarily driven by a narrowing of the trade surplus on the back of robust growth in private consumption (and to a lesser extent, investment), which will lift import growth over that of exports. We assume that the constitutional reform and a left-led government will weigh on investor confidence (both domestic and foreign), causing inward foreign direct investment (FDI) to fall over the period. However, FDI inflows are expected to be sufficient to cover the current-account deficit completely, preventing a rundown of foreign reserves.

With just five months left in office, a second impeachment proceeding was launched against President Sabastian Pinera in October. The new action is a result of Pinera's alleged involvement in an irregular sale of a mining company in 2010. In response Mr. Pinera pointed out that his investments were placed in a blind trust at the time (as he was president).

Over 2022-23 government-backed loan guarantees will remain available. Domestic long-term interest rates are high and bank lending practices are conservative. Larger Chilean firms will continue to retain reasonable access to bond markets.

Reforms to increase minimum wages, reduce working hours, and other forms of labor protection will be an important subject of the constitutional reform. We expect reforms in the new constitution to include greater state control in some sectors, such as electricity and mining. These will include stricter conditions imposed on mining concessions and limits on the scope of entry for new firms going forward. Trade unions will remain strong. Relations with China (Chile's largest trading partner) will remain strong, but slower Chinese growth could begin to affect China's

demand [quantity] for Chilean raw materials in 2022-23.

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