Major Country Risk Developments
October 2021

By Byron Shoulton

Overview

For months, much of the global economy has expanded at a swift pace, as industries that were shut down in the pandemic have reopened. Further economic healing is likely to be more gradual, and in some ways more difficult, as supply shortages continue to hold back many parts of the economy. A range of risks including unpredictable coronavirus variants could upset the transition toward a healthy post-pandemic economic recovery. Political factors also play a role: In the U.S. the standoff over a rising federal debt could bring the nation close to the brink of default. What's now in place is a temporary solution that expires on December 6th, 2021.

Some observers wonder if the world economy is now facing a buildup in stagflationary forces as surging energy prices boost inflation and appear to slow the recovery from the pandemic-induced recession. The climb in oil prices to the $80 per barrel range for the first time in three years, and natural gas prices for October delivery trading at the costliest in seven years caused the Bloomberg Commodity Spot Index to rise to the highest level in a decade. Food prices are also advancing, driven in part by crop failures in Brazil, flooding in Colombia, drought conditions elsewhere; versus strong global demand which helped drive the benchmark food index up 33% over the past 12 months. The shortfall in global energy supplies has pushed oil prices to its highest in three years, and record gas prices is exacerbating the market's already tight supply-and-demand balance.

Rising spending costs to households and companies are undermining confidence in the sustainability of the recovery, while pushing inflation faster than expected only a few months ago. This could put policymakers in the uncomfortable position of having to choose whether accelerating prices or weaker growth poses a greater risk to the economy. Among the concerns is that more enduring price increases in the months ahead will feed into demand for higher pay, tipping the economy into a vicious cycle.

Meanwhile, OPEC and a Russia-led group of oil producers opted to continue increasing production but only in measured steps, providing no ease to current price pressures. By deciding against opening the taps more widely, the group drove crude prices to their highest levels since 2014. Many will blame OPEC+ as being complicit if a year from now it is concluded that by not changing its tough production and pricing posture now, the cartel has unwittingly contributed to a vicious upward global cost spiral that has hit industry, consumers, home-heating, transportation, and the services sectors all at once. This could potentially lay the groundwork for a longer-term trend of inflationary price spikes that undermine the sustainability of the global recovery.

OPEC has warned consumers to brace for more energy shortages unless the world boosts investment in new oil and gas development, marking the energy cartel's first response to increasing calls to limit such spending. Meanwhile, big oil companies have made moves to curb emissions and pivot toward renewable energy sources, spurred by pressure from investors, customers, governments, and courts. If that all results in lower investment in finding and pumping new deposits of crude and natural gas, the world risks more of the sort of energy-price volatility we are now seeing.

Natural gas prices have soared amid low inventories in the Europe and Asia, while high coal and gas prices and government efforts to cut electricity use have led to power cuts in China. Natural gas prices in Europe

and Asia are now almost double the price of oil for the equivalent energy. For some this is a breakthrough moment in the global gas market, a preview of things to come as the energy transition accelerates and demand shifts from dirtier fossil fuels. Another analysis is that current prices may simply reflect a competitive market responding to an unusual confluence of economic forces. In the future, a sharp correction is possible. As we move into 2022, some of the one-off demand increases in South America and north-east Asia are unlikely to repeat themselves, even as China's appetite for gas continues to grow.

Some of the LNG supply issues are already beginning to ease and there are new plants expected to start up in the U.S. Flows from Russia through the Nordstream 2 pipeline are also expected to start later in 2022. These could help cool prices later in 2022. The global energy crunch comes at a time of extra-ordinary demand, as economies bounce back after near hibernation. If the threat of stagflation is annoying in the developed world, it could be calamitous in the developing world. Emerging-market consumer price index baskets are more heavily weighted to volatile food and energy prices. Because of this and because of past inflation scares, emerging market central banks have to be much more reactive to maintain their credibility and keep inflation in check. And when developed market central banks are tightening, that weakens emerging market currencies, making inflation worse and reducing or reversing capital flows. No wonder that in emerging markets among the most dominant financial factors is the U.S. Federal Reserve.

For now, there is some good news for emerging market countries, especially those like Nigeria, Brazil and Russia that export energy. But for energy importers such as Turkey, India and China recent high energy prices are an additional burden. Many emerging market central banks are grasping the weight of the current situation and tightening interest rates. Russia has pushed rates from 4.25% to 6.67% this year; Brazil, from 2% to 6.25%; and Mexico, from 4% to 4.75%. Others, such as Turkey and South Africa, are holding back.

This is a tough, uncertain environment. Inflation could remain a threat, and 2022 growth expectations are down. It may not be stagflation but a stagflation-like environment, which is tough for emerging market countries which rely on growth, as the growth outlook is currently not rosy. Furthermore, emerging markets have had less vaccine access, and most of them do not have the fiscal capacity to stimulate their economies significantly, and now they are confronted with the likelihood of U.S. monetary tightening in the year ahead.

USA

The OECD projects that 2022 growth of the world economy will be 4.5%, downshifting from an expected 5.7% in 2021. The forecast for the U.S. shows an even steeper slowdown, from 6% growth this year to 3.9% in 2022. U.S. recovery prospects are hedged by concerns over higher energy and commodity prices, which has helped spike higher prices on a range of products and services. Price increases for energy supplies, food, household products, transportation, manufacturing, plus rising labor costs have been significant over the past year. Worldwide shortages of finished products remain noticeable as well.

In some instances, shortages in the U.S. diminished for a while during the spring and early summer but have started to grow again. In the U.S. -across the board reports of worker shortages have hit a variety of sectors including hospitality, transportation, restaurants, hospitals, retail, pharmaceutical, services, manufacturing and delivery. There's no immediate relief in sight.

In addition, new shortages of paper products, spare parts, components, and continued delivery delays remain a problem. The unpredictability of the virus coupled with the natural human desire to interact, in an intertwined global economy – the transitioning to

the next phase of this

recovery promises to be rocky for many businesses and households. Even if the pandemic gets under control in most of the world by October 2022, it is likely that we could be living with the effects or side-effects of the virus even longer. Consumer confidence has weakened in the U.S. as higher prices influence more buying decisions. Still, overall U.S. spending rose as the Delta variant began to loosen its grip. The pandemic could still throw the U.S. economy one more punch. It was around this time in 2020, as cooler weather began sending more people indoors, that Covid cases began climbing again. According to an analysis conducted by JP Morgan, in the final three weeks of September (last month) the number of Covid cases has been rising fastest in states with lower average temperatures. It is not yet time to celebrate.

Furthermore, unlike the recovery from the 2008-09 financial crisis, companies report that they are struggling to find enough workers and raw materials to meet ongoing demand. Such strains, are in effect, acting as brakes that slow expansion. The question is how much, and for how long, those brakes will be applied.

The U.S. has become a major exporter of liquefied natural gas, and some industrial users are urging the authorities to keep that fuel at home if prices get too high. While politicians may find the temptation to limit U.S. LNG exports this winter, such curbs could potentially backfire. Exercising that option could prove detrimental to the U.S. reputation as an energy exporter, affecting developers' ability to sign new contracts around the world. Many importers are utilities with an obligation to make sure consumers in their respective countries have access to heat and electricity. Failing to send promised LNG cargo at the height of winter could prove unforgiving.

That context is relevant as the growth outlook for U.S. natural gas depends heavily on overseas demand. Domestic natural gas consumption is slated to grow at a sleepy average annual rate of 0.7% from 2020-2024, while the Asia Pacific region, a strong importer, is expected to see average growth of 4.5%, according to the International Energy Agency. U.S. gas production growth will be driven mainly by its growing LNG export capacity.

Europe

In the UK, consumer confidence fell in September at its sharpest pace since lockdown rules were tightened a year ago as British workers and households braced for a looming income squeeze. In addition to a run on gas stations following a shortage of truck drivers to deliver fuel, the UK along with much of Europe is suffering a surge in electricity and natural gas prices triggered by a post-lockdown demand surge and lower inventories left over from last season. That has undermined already fragile consumer sentiment. Higher energy prices hit disposable incomes directly and often contributes to weakening confidence. This is a particularly sensitive period with rising virus numbers seemingly subverting the nascent economic recovery. The UK Petrol Retailers Association reported signs the recent crisis at the pumps has eased, with only 27% of its members reporting being out of gasoline.

The latest bout of commodity-price surge has taken markets by surprise just as major central bankers were starting to signal their intention to begin gradually removing stimulus measures. The Bank of England highlighted the conundrum facing central bankers by citing the limits of monetary policy in dealing with some of the factors causing higher consumer prices. The current shocks are restricting supply in the economy relative to the recovery in demand. This is important to note as monetary policy will not increase the supply of semi-conductor chips, raw materials or components needed to complete the manufacturing of finished products and delivering them to consumers on time. Returning the global economy to a reasonable balance between demand and supply is among the top challenges facing

policymakers, markets, businesses, and consumers as all look to advance recovery efforts. An early resolution appears unlikely given the multitude of conflicting trends which dominate. These include business and consumer uncertainty, investment aversion, high government debt levels, geopolitical tensions, and mistrust.

For many advanced economies, the silver lining is that most have generally recovered from the recession better than anticipated. Gross Domestic Product could return to pre-crisis trajectory in 2022, according to forecast from the OECD, a stronger outcome than it predicted in late 2020. However, while leading central bankers have warned against overreacting to "transitory supply shocks", not everyone is convinced that the shocks now being experienced are indeed transitory trends.

Recent data highlight what appears to be a two-speed global recovery. In the eurozone, consumer activity is now back to pre-pandemic levels. Restaurants across the Eurozone are serving up dishes to increasing numbers, as Europeans shop, venture out more and increase their use of public transportation. Higher vaccination rates have helped to fuel confidence, schools have reopened, and workers are returning to offices. Nomura predicts growth of 2.3% for the euro-zone in the third quarter. However, Europe is not yet out of the woods. Eurozone recovery still lags behind the U.S. and China, while manufacturers still face a host of supply chain problems. Together with stubborn new infectious cases of the Delta variant, this contributes to lowering consumer confidence [now at seven-month lows].

Rising Covid-19 infections in Asia-Pacific are putting the brakes on economic activity in that region as well. The World Bank has drastically cut 2021 forecasts for Asia -Pacific (excluding China) by two percentage points to a meagre 2.5% because of rising Delta cases and lackluster vaccination programs. Poorer households are bearing the brunt of the slowdown. One example is Vietnam, which reported a record fall in activity of more than six per cent in the third quarter, as the country struggles to cope with the surge in infections around the pivotal Ho Chi Minh City business district. Recent data shows that the region has sped up its vaccination rates lately, an encouraging and welcome development for Vietnamese factories and employment opportunities.

Meanwhile, rising numbers of Covid cases in Australia has prompted businesses [including names such as BHP, Macquire and Qantas] to warn that resulting lockdowns are creating long-lasting economic problems. Echoing complaints heard in western capitals earlier in the pandemic, the Business Council of Australia suggested that as vaccination rates increase, it will become necessary to open up society as communities learn to live with the virus, the way other countries have done.

China

Sharp cuts in production across a range of energy-intensive industries in China are now expected to drag growth lower this year. Foreign investors in the Chinese property giant Evergrande's huge debt load face the challenge of navigating an uncertain, complicated international debt restructuring pathway for the company. The Chinese authorities have sent the message that it will attempt to facilitate an orderly debt restructuring but not a wholesale state-financed bailout for the highly indebted real estate developer. How Evergrande's restructuring is handled could become a pattern on what to expect when other Chinese entities face default on heavy debt, large portions of which are held by foreigners. Some reports suggest that the huge developer could end up being sold off in pieces.

Military tensions around Taiwan increased as China sent a record 52 warplanes into the country's air defense zone after the U.S. and five allies held a large naval exercise east of Taiwan. The incursion announced by Taiwan's defense ministry marked the third time in four days that the People's Liberation

Army set a new record for flying into Taiwan's air buffer zone [145 flights in three days]. Taiwanese officials declared that the scale of PLA's activity near Taiwan has reached a dangerous level, close to the brink of conflict.

Japan's Maritime Self Defense Forces explained that the navies of the U.S., Japan, the UK, Canada, the Netherlands, and New Zealand conducted a large exercise involving aircraft carriers and 14 warships south-west of Okinawa in Japan. The soaring tensions comes as the U.S. and several allies and partners are stepping up military cooperation in the Indo-Pacific in response to China's increasingly aggressive use of its growing military capabilities. China claims Taiwan as its territory and threatens to invade if Taipei refuses to submit to its control.

Meanwhile, Chinese cities are currently facing weeks-long power shortages related to spiraling coal costs, coupled with new government emission control measures, that has left communities in the dark and forced some factories to close, sometimes partially.

The crisis is exaggerated by the government's conduct of a grand experiment in 21st century authoritarian governance. The ongoing clampdown on big-tech firms and manufacturers operating in China was demonstrated by the Chinese government's recent demand that Tesla (the American electric car maverick) convinced it that the company is not being used to spy on China. Tesla cars have been banned from entering Chinese military compounds. In recent weeks, Beijing has pushed through reams of regulations and policies designed to shore up China's data security, reinforcing the control it exercises over huge volumes of data used in governing the country, boosting the economy, and monitoring all types of activity.

Some envision in China the making of a techno-authoritarian superpower, in which all activities are monitored, and people are directed to unprecedented degrees via government-controlled cyber networks, surveillance systems and algorithms. Chinese researchers explain that with better control over data the government can not only build a more productive economy, but also a more efficient government that makes decisions based on hard science rather than intuition. The idea is that the embrace of digital sovereignty will play a key role in protecting Chinese national interests against enemy forces at home and abroad. The Chinese leadership has stressed that whoever controls data has the upper hand. Data is seen as the fifth factor of production in official 2020 classification, along with labor, land, capital, and technology.

Personal data is collected not only through online interactions but also through a series of technologies designed to order and control a society of 1.4 billion people. The leadership has emphasized for some time, that control of information has become an important aspect of China's soft power and competitiveness. In keeping with this goal digital social security cards, digital money, smart cities, surveillance cameras, social credit systems, and other advanced technologies are being rolled out across China. Some believe these efforts are meant to suppress political descent without damping the entrepreneurial vigor or the innovation which has driven the world's fastest-growing large economy. Fostering innovation is still a top-line priority for Beijing. New rules on data protection and control are meant to be the nexus that guides development direction and determines the ultimate shape of China's digital economy.

The trove of data is meant to be bent to the will of the state. Beijing has adopted a multi-pronged approach to attaining this goal: laws that govern data's use. Increasing the state's access to data in the private sector; and the state itself collecting vast data inventories on its own. The hardening of China's legal regime around the use of data, is not surprisingly, leading to disruptions for multinationals operating in China, large Chinese corporations and players in the financial markets. One law, the Personal Information

Protection Law, which is due to take effect in November, stipulates that data moved out of China must either first pass a security assessment by the Cyberspace Administration of China, a government regulator, or obtain other forms of official approval. Another law which came into effect this month, the Data Security Law, requires the protection of "important data" and "core data", the latter of which is defined as information involving national and economic security, people's welfare or important public interest. The definitions are so broad, they could cover almost anything related to private data.

The laws mean or will mean that all data generated in China must stay in China unless there is explicit permission to send some data overseas on a case-by-case basis. China is becoming a data empire unto itself. This leaves multinationals operating in China with little choice but to establish data centers to keep all their customer data collected by a multinational in China.

The new data regime is tearing apart a U.S.-China capital market relationship under which 248 Chinese companies with a total market capitalization of $2.1 trillion had listed on U.S. exchanges as of May of this year. The future of mainland Chinese listings in Hong Kong is also clouded by the new data regulations. Separately, China has filed an application for membership in the Comprehensive Trans Pacific Partnership Trade Agreement (CPPT) originally a trade grouping of countries formed to counter China's market dominance. The move is viewed as a counter measure against Taiwan which has indicated that it too will also seek to join the trade group.

Vietnam

The county is loosening a strict, three-month lockdown in Ho Chi Minh City after a stark warning from businesses and a record quarterly fall in GDP. The lifting of constraints on movement, factory work and other activities in Vietnam's business capital, follows a decision by the country's leaders to scrap its "zero-covid" strategy in favor of a more flexible approach.

Effective October 1, 2021, Ho Chi Minh City's local government is allowing gatherings of up to 10 people, or up to 50 - if all are fully vaccinated or recovered from Covid-19. The city will introduce a "green card" system giving greater freedom to operate normally for companies whose staff have received two vaccine doses. Some seven million residents in the city of 10 million have received at least one dose of the vaccine and three million people have received two doses thus far, according to Vietnam's Ministry of Health.

The moves toward easing restrictions came after complaints from companies (including foreign investors) that drive the Vietnamese economy – who warned the government that its strict social-distancing measures in and around Ho Chi Minh City were crippling business, hurting exports, and prompting some companies to move production abroad.

After enforcing tough quarantine and track and tracing measures in 2020, Vietnam contained new local infections and became one of Asia's few economies to grow. However, since mid-2021, the country suffered an outbreak of the Delta variant – focused on Ho Chi Minh City, exposing failings in the government's procurement and administration of vaccines. Since July 8, 2021, authorities imposed a 12-hour curfew and lockdown in the city, which was tightened to restrict nearly all movement, including between the provinces and local districts. Companies were forced to choose between shouldering the cost of housing and feeding workers in their factories or suspending production.

The lockdown measures hit hardest in labor-intensive sectors such as clothing and footwear, but electronics producers were hit as well. Companies that suffered problems with their suppliers included Apple, Samsung, Toyota, and Nike. The economy contracted by 6.2% during the third quarter, the sharpest decline of GDP since Vietnam began keeping such records.

The government has acknowledged that it can no longer pursue the "zero covid" strategy and will instead revert to a new normal policy of aiming to contain the disease. At a meeting of the government's national steering committee, the health ministry adopted guidelines for what it called "safe adaptation, flexibility and effective control of the Covid-19 pandemic". The country has reported 780,000 infections and 19,000 deaths from the virus, nearly all of which have been logged since the beginning of July this year. Infection rates have slowed in recent weeks after peaking in late August.

Business advocated for a clear road map and a date for reopening the country. The U.S., EU, and South Korean chambers of commerce in Vietnam wrote to the government, indicating that at least 20% of their manufacturing members had already shifted some production to another country. Other discussions were also underway because of the steep lockdown measures. The curbs hit operations in labor-intensive sectors. The operations of suppliers to Intel, Ikea, Adidas, and Nike were all disrupted.

In addition to the bans on movement around Ho Chi Minh City, where the greater urban area sprawl into neighboring provinces that have different rules, businesses have voiced frustration with restrictions on the entry to Vietnam by foreign professionals. Policies intended to control the spread of the virus have caused significant operational challenges for businesses in Vietnam, especially with frequent changes to regulations that are announced and implemented at very short notice. The restrictions were considered economy-crippling and not sustainable following months of severe restrictions on activities and movement. Companies have expressed relief that the government has moved to ease the rules and are pleased to see economic activity gradually resume.

The business backlash poses a challenge to the sitting government which took power in April after a five-yearly shake-up of Vietnam's ruling communist party. Before the pandemic Vietnam had one of Asia's fastest growing economies, thanks to investor friendly tax and other business friendly policies, and a network of free trade agreements. Vietnam is a member of the Comprehensive & Progressive Agreement for Trans-Pacific Partnership (CPTPP) and has a free trade deal with the EU.

Vietnam, which before the pandemic was a leading destination for multinational companies looking to diversify operations away from China, was missing out on new investment opportunities as long as the restrictions remained in place. Even existing businesses operating in the country had placed most of their investment plans on hold.

Peru

The new government of President Castillo wants mining companies operating in Peru to pay more towards improving living conditions for the poor. The provision is included in a list of criteria that mining companies must meet if they are to continue operating in the country.

The new guidelines relate to economic issues, and include environmental regulations, labor laws and community relations. The new Peruvian Ministry of Mines has encouraged mining companies to make sure that they meet all the conditions included in the new regulations in order to continue operating in the country.

As the Castillo leftwing government settles in to govern, the mining sector is the most important sector, the largest revenue generator to the government and the largest export earning (foreign exchange) source to the country. The sector contributes 60% of export revenues as the world's second-largest copper producer. Peru is also an important source of gold, silver, zinc, tin, and iron ore to the global market.

Multinationals such as Anglo American, Newmont, Glencore, and Freeport-McMoran operate in Peru, as

do Chinese controlled companies including MMG Ltd., and Chinalco and local mining companies such as Buenaventura.

The new Castillo administration says the sector must contribute more to help pay for education and health spending, but how much more remains unclear. During the election campaign last year, Free Peru, the Marxist-Leninist party that propelled President Castillo to power – said miners should hand over 80% of their profits and warned that if they refused "the state must proceed with nationalization".

Castillo has since unveiled a more moderate plan, but even so it proposes "a new tax on profits" for mining companies and "an end to tax breaks". "We must nationalize our wealth, that is, make it serve Peruvians, with new rules of taxes and royalties," it says. The mining minister explained recently that the government was still evaluating these changes. He hoped to have a clearer idea about the new tax regime within 100 days. On the issue of royalties, Peru is intent on employing the best practices used in other countries. The Peruvians are closely watching the structures in effect in neighboring Chile.

Currently, there is legislation before Peru's senate which would oblige copper miners to pay royalties on a sliding scale tied to the price of the metal. When it rises above $4 per pound -as it has this year, hitting a historic high of $4.76 per pound in May – royalties would amount to 75% of sales.

The mining sector lobby in Peru says that this year, fueled by high commodity prices, it will contribute approximately $3 billion in taxes and other payments to the state – a record and more than twice as much as in 2019, before the pandemic. The lobby group representing the mining companies have disclosed that they pay eight different taxes and charges to Peruvian authorities – which amount to 50% of their profits. The companies claim this is a heavier burden than in any other mining country (with which Peru competes). The companies calculate that they will pay $20 billion over the next five years to the Peruvian state (at existing tax rates). This would be the highest intake to the state in its history for any five year period. Mining companies say the problem is not the amount of money they generate but instead how the money they pay the state is spent at the local level. Once companies pay their corporate taxes, the central government redistributes half of those amounts to local and regional governments. The companies estimate that about 61% of that half is ever reinvested.

President Castillo says he wants to renegotiate tax stability agreements that companies signed with previous governments. These contracts give firms a long-term vision of their liabilities and are regarded as essential in assessing their investment. MMG Ltd., a subsidiary of China Minmetals Corporation, has a tax liability agreement in place until 2030 at its massive Las Bambas mine high in the Andes. Chinalco has a similar deal at its Toromocho mine until 2028. Anglo American and Japan's Mitsubishi, who are building the $5.3 billion Quellaveco mine in southern Peru, have an agreement until 2037. These companies will be reluctant to renegotiate those arrangements.

While trying to squeeze more cash from miners, Castillo also must play to his own electoral base. Many who voted for him in June are from poor, remote mining areas of the Andes and their expectations for wealth redistribution are sky high. They want the government to deliver on its campaign promise "no more poor people in a rich country".

In some communities 97% of voters voted for Castillo. Protests against at the Chinese-owned Las Bambas mine has been loud for some time. Local farmers say the constant convoys of trucks leaving the mine on a dirt road generate dust clouds that ruin their crops. Shortly after assuming office, Castillo dispatched his Prime Minister to the area to sort out the dispute. The farmers have agreed to halt their protests for 60 days while a solution is found. Farmers warned "we're all supporters of Castillo but if we don't see progress in the time allotted, we'll start protesting again".

The coming months will likely involve tax tug of war between the government and the mining companies, with the government insisting its proposed changes are long overdue. Mining companies and other foreign investors face a difficult period ahead in Peru.

By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at bshoulton@fcia.com

Although FCIA has made every effort to insure the accuracy of this publication we do not accept any responsibility whatsoever for - including but not limited to - errors, omissions, opinions or advice given. This publication is not a substitute for professional advice and all information is for guidance only. Coverage descriptions in this brochure are summarized. Consult the policy declarations and policy form for a full description of the applicable terms, conditions, limits and exclusions. Policies are underwritten by Great American Insurance Company, which is an authorized insurer in 50 states and the District of Columbia © Copyright 2021 by FCIA Trade Risk & Political Risk. FCIA logo (letters and design) are registered service marks of Great American Insurance Company. All rights reserved.