Trade Credit & Political Risk

Major Country Risk Developments
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Overview

A surge in food and fuel prices is raising pressure on governments around the world to pick up the tab for consumers, stretching precarious public finances and intensifying political instability in some of the shakiest economies. Spooked by protests that have broken out recently from Bangkok to Sicily, many governments have adopted subsidies or tax breaks to shield households and businesses from the soaring prices. Yet these handouts are boosting already high government debt just as borrowing costs are rising. For some countries, the increase may prove too much to afford, raising the specter of political unrest.

According to recently released data, the value of global trade fell 2.8% between February and March as the Russia-Ukraine war hit container traffic. As well as affecting trade in Russia and Ukraine, the war has hit the European Union (EU) badly, reducing exports by 5.6% and imports by 3.4% in March. In the U.S. exports were down 3.4% and imports down 0.6%, while the impact on China was negligible.

Inflation in OECD countries reached a 30-year high of 7.7% in February, even before the fresh hit to the global economy from the war in Ukraine, with energy and food prices being the main culprits. The Bank of International Settlements confirmed that higher inflation looked set to last for some time, posing long-term problems for central banks and risking a "dangerous wage-price spiral."

Meanwhile rising political risks will tend to halt and reverse globalization. The focus on efficiencies in the delivery of raw materials, components and finished goods will be balanced by a new emphasis on resilience in the face of supply-chain disruptions and shortages which have only worsened with the onset of the Russia-Ukraine war.

The war and the worsening crunch in international trade have given more urgency to a trend that had already been building up steam: governments wanting to improve supply-chains. Semiconductors are high on the list for securing vital supplies and building up domestic capacities.

Semiconductors are a tough test of the ability of industrial policy to target interventions precisely, given the complex globalized supply chain involving multiple stages of R&D, production and distribution. In the light of global semiconductor shortages (potentially worsened by the war on Ukraine), the U.S. and the EU are each passing a Chips Act to secure supply. They and other big semiconductor producers (Taiwan, South Korea, Japan) will try to coordinate their interventions, so they don't end up duplicating efforts.

The challenge is achieving diversification without duplication. In the EU, a big chunk of money is being spent getting Intel (U.S.) to invest: it's vital to have more of the manufacturing part of the supply chain onshored in Europe because it is already so entrenched in producing chips. Nonetheless, other governments want some of the action. It is envisioned to have research facilities in the U.S. to connect with American universities [and federal dollars] in this country. It won't be politically acceptable to have full separation of the supply chain, to do only one aspect in one country and other functions someplace else. The ambition is building bridges and connecting continents, having satellite facilities across the globe. One danger is that governments will push for walled-off supply chains. While doing no production on U.S. soil is probably not politically realistic, duplicating functions does not make sense either.

There's a lot of public money being thrown at the chip problem, but the risks of poor coordination, special interest lobbying and economic nationalism, means it will be a challenge to make these efforts land in the right place.

The boycott of Russia since the Ukraine invasion is expected to have lasting effects on energy markets. Leading oil traders are predicting that crude and refined products such as diesel from Russia are unlikely to return to the European market any time soon. They also forecast that crude prices could climb to $200 per barrel in 2022 due to the growing international boycott of Russia and lack of immediate alternative sources of supply. This suggests that the Russian war in Ukraine could lead to a lasting reshaping of global energy markets. Oil traders see the current energy situation as a long-term issue requiring a need for alternative supply growth.

However, the U.S. shale oil industry is unlikely to provide short-term relief. While U.S. shale producers were once known for its debt-fueled production binges, companies have since pledged not to overspend cash flow and burn through capital on costly projects. Oil prices in the futures market would need to rise significantly before the U.S. shale industry would increase production and deliver the cash returns expected by investors.

Europe

Russia's attack on Ukraine saw gasoline and diesel prices make their biggest jumps since the oil shocks of the 1970's against the backdrop of already rampant inflation. After chafing under Covid-19 restrictions, Europeans are now protesting over their dwindling purchasing power.

The Ukrainian war has also clobbered EU farmers, with implications for global agriculture. The war is forcing the European farming sector to take some tough decisions as the Russian invasion of its neighbor squeezes grain supplies and sends the cost of energy and other raw materials skyrocketing. Farming is under unprecedented pressure in Europe [and elsewhere] as the cost of fertilizer, animal feed and energy has been made worse by the ongoing Ukraine war.

The European Union gets half of its corn from Ukraine and a third of its fertilizer from Russia. This caused Brussels to ease state aid rules to support EU farmers as well as allowing access to a 500 million euros crisis fund. The EU will also bring forward annual agricultural subsidy payments from December to October to help with cash flow and will assist pig producers with the cost of cold storage of carcasses for up to five months, in anticipation of meat being released to the market when prices improve.

Europe is one of the world's leading agricultural producers and is a net food exporter. Stricken farmers are having difficulty accessing credit as their financial problems mount. Farmers complain they are unable to immediately pass on rapid cost increases to customers, leading to cash flow problems.

In Ireland farmers are calling for 100 million euros in government loans to save the Irish pig sector -worth 1 billion euros in annual exports. Higher fertilizer costs will also affect beef farmers in Ireland, where most cattle are grass-fed, with any cut in crop nutrients reducing hay and silage yields.

In Spain, Europe's largest pork producer with annual production of 5 million tons per year, there are serious concerns relating to animal feed: about 22% of the corn fed to livestock in Spain comes from Ukraine.

Farmers complain that they have had five months of high prices for cereals and low price for meat, even before the war in Ukraine - which added to already high costs for animal feed. Increasing fertilizer prices, which rose to record levels in March is another worry for crop growers. Russia is a leading exporter of nitrogen, phosphate and potash fertilizers.

In Italy, farmers preparing for spring sowing of corn, sunflowers, soya and tomatoes are experiencing 40% decline in fertilizer supplies compared with previous years. Spring is also a crucial period for fertilizing soft wheat and durum wheat and the overall cultivation costs for growers of the crop has risen as much as 60% per hectare. There is a fear that due to the very high costs, the productivity of wheat and other agricultural products may be lost.

Fertilizer prices, which hit record levels in March, are an increasing worry. Russia is a key exporter of nitrogen, phosphate and potash fertilizers. The situation is also being made worse by a reported lack of competition in the U.S. fertilizer industry. The World Trade Organization is concerned that governments risk repeating mistakes of earlier food crises by imposing export controls as commodity and energy prices spiral. The WTO is urging governments with surplus stocks of products such as vegetable oils and grains to sell them on world markets. The UN's food price index has already risen by 24% over the last 12 months and is set to rise further. This means higher grocery bills and in some cases the possibility of a food crisis and a spike in hunger among the world's poorest communities.

The problem reaches much further than Europe. It is also feeding through into prices consumers see at checkouts across the globe. In the Middle East - particularly countries like Lebanon and Egypt, which purchase 70% of wheat imports from Ukraine. Egypt, the worlds largest wheat importer, relies on Russia and Ukraine for more than 80% of the wheat it buys on international markets.

China

In China strict Covid lockdowns are exacerbating serious shortages of fertilizer, labor and seeds, just as many of the country's biggest agricultural provinces prepare for their crucial spring planting season. According to official data as many as a third of farmers in China's three northeastern provinces have insufficient agricultural inputs after officials sealed off villages to fight the pandemic. The three provinces account for more than 20% of China's grain production.

A fall in output of China's spring-planted grains, such as rice and corn, could undermine Beijing's decades-long effort to achieve self-sufficiency in staple foods, forcing it to increase imports and potentially adding to global price inflation.

While national and global attention has been focused on Shanghai's lockdown of its entire population in recent weeks, Jilin province has been battling an outbreak of Covid with stricter measures for the past month. According to the Jilin provincial government, about one-third of farmers do not have enough fertilizer at the end of March – just three weeks prior to the beginning of the planting season. Jilin province has reported 50,000 Covid cases since March and many townships refuse to allow in trucks from other regions, even if they are bringing seeds and fertilizers that are not available locally. This is a trend repeated in other farming provinces and towns.

Farmers and factory managers have blamed the disruption on China's uncompromising zero-Covid policy, under which authorities have adopted tough controls ranging from traffic bans to local business shutdowns. Some advisers to the central government conclude that China risks facing food shortages. The spring planting problems come as the war in Ukraine has stopped shipments of corn, an important livestock feed, to China. Ukraine has been shipping corn to China since 2013 and became its top overseas supplier two years later, according to data from the International Trade Center.

Chinese fertilizer factories are struggling. A leading fertilizer producer in Hebei province, confirmed that his firm was having difficulty shipping to customers and securing raw materials. The problem is said to be industry-wide with smaller producers having to suspend operations.

Compounding farmers' frustrations, many migrant workers are stuck in lockdown cities and are unable to return to rural areas for planting. Those who do make it to the farms are required to spend 14 days in quarantine before they can start working in the fields.

Meanwhile, the approaching crisis has provided opportunities for countries producing fertilizers and its inputs, wheat, corn and other agricultural goods, (U.S., Canada, Brazil, Argentina, among others) to begin beefing up production given a spike in orders from countries that had previously relied on Russia and Ukraine for their supplies.

USA

Economic growth has been strong, buoyed by low unemployment, continued consumer demand, stimulus money and resilient equity markets. However, inflation at 7.5% and climbing will remain the leading issue for U.S. consumers, companies and markets over 2022- 2023. This is forcing aggressive interest rate increases going forward, after much hesitancy by the Federal Reserve over the past 12 months.

The Fed and the Administration misjudged the issue until the reality of high, rising and persistent inflation became too obvious to deny. It is now clear that inflation cannot be tamed unless interest rates rise above the inflation rate and remain there until the pace of inflation begins to slow substantially. The challenge will be how to maintain such high interest rates without damaging consumer confidence and hence economic growth; and possibly causing a recession.

Furthermore, the effects of the pandemic on labor [a shift from surplus labor during the last two decades] to current stubborn labor shortages as populations age and the share of working-age people decline, won't just disappear. Workers are pushing and are receiving higher wages, which will drive production costs and prices higher. Running a hot economy with high growth (5%) and low unemployment (3.6%) will likely spur uncomfortable levels of inflation. Achieving price stability will inevitably require higher interest rates than Americans enjoyed in recent decades. This will put pressure on private investment, the cost of financing public debt and eventually raise the unemployment rate. Unless there's a surge in productivity, long-term growth in output and wages will slow.

Market consensus calls for the economy slowing through the end of next year, but not necessarily falling into a recession (this is the most optimistic view). Note that U.S. consumer sentiment as measured by the University of Michigan, is lower today than it was at the depths of the pandemic. It has entered 2008-09 territory and is not far from lows of

the 80's when inflation hit double digits. The economy succumbed to recession in each of those periods.

In the meanwhile, the Fed is preparing to slash the size of its swollen $9 trillion balance sheet by $95 billion a month – as it steps up efforts to curb soaring inflation, according to minutes of the March Federal Open Market Committee meeting.

This amounts to the central bank's asset reductions in U.S. government bond markets of just under $1 trillion a year. The process is expected to begin next month. This is a clear indication that the Fed recognizes that there is the need to act decisively to cool down the U.S. economy after raising interest rates.

The war in Ukraine together with high energy costs and soaring inflation is slowing the recovery from the pandemic. This is undermining consumer and business confidence which has been shaken by a fresh dose of uncertainty.

While U.S. wheat farmers should be in a good position to help buffer some of the pain from agricultural disruptions in Ukraine and Russia, they are worried about inflation of another sort – in fertilizer.

The war is part of that problem, too. Russia was until recently the second largest foreign exporter of fertilizer to the U.S., providing 10% of the total supply. A March 11 release from the U.S. Department of Agriculture explains "fertilizer prices have more than doubled since last year due to many factors including Putin's price hike, a limited supply of relevant minerals and high energy costs, high global demand and agricultural commodity prices, reliance on fertilizer imports, and lack of competition in the fertilizer industry."

Germany

Some recent studies by prominent economists in Germany suggest that an immediate stop of imports of Russian energy would reduce German economic growth by only a modest amount. The German government disagrees with that conclusion as do the country's industrial lobby group and trade unions. The latter believes that a ban on Russian energy would lead to high unemployment, mass poverty and a deep recession.

A number of opposition politicians and independent economists insist that the consequences would be more manageable.

More than half the natural gas consumed in Germany comes from Russia – the highest share for any major EU economy – and gas reliant industries are warning that by next winter their operations could be at the mercy of Moscow. Meanwhile, Germany has activated the first stage of an emergency plan to mange gas supplies in case Russia stops supplies. Russia is threating to do so because Germany and the rest of the G7 countries are refusing to accept its demand that "unfriendly" countries pay for gas in rubles, rather than in dollars or euros, which sanctions have made it hard for Russia to use.

Germany has been buying $2 billion worth of Russian oil, gas and coal per month, thereby helping finance the war against Ukraine. The Russian government believes stopping the flow would hurt Germany more than Russia, even while other European governments have called for an embargo of Russian energy supplies.

A think-tank close to Germany's trade unions published a study which supports the government's assessment. The study suggests that halting Russian energy imports would cause a recession -GDP would shrink by 6%- even if alternative supplies could make up for half of the gas supplied by Russia. This conclusion is similar to that of a German industrial lobby group BDI, which includes leading chemical and steel companies who are concerned that Russian gas cannot be replaced in the short term. Industrialists complain that the German government has failed to prepare for an energy crisis. Germany and Europe have so far failed to secure an alternative source for gas supplies. Under a law put in place during Mid-Eastern exporters' oil embargo of the 1970's, German industry would be forced to curtail gas consumption in the event of a shortage, with supplies reserved for critical infrastructure and households. Such a step would cost Europe's largest economy tens of billions of euros and could plunge it into a recession.

Energy- intensive German groups such as steel and chemical manufacturers opine that such a crisis would be worse that the Covid-19 pandemic. The Coronavirus hit German companies and exporters hard, but thanks in part to demand from China, there was soon an economic recovery. The current energy crisis is of even greater concern. About 15% of Germany's gas supply is consumed by the chemical sector. BASF the world's largest integrated chemical complex- uses almost 4% of the country's gas. The company acknowledged that Steam crackers – units that break hydrocarbons into basic chemical components- would come to a complete standstill if gas deliveries fell below 50% of their normal levels, endangering the supply of substances used for medical, hygiene and food products.

Separately, while gas used for electricity generation can be replaced by coal-fired power stations, its role as a raw material or a fuel for blast furnaces and other industrial processes is not easily substituted.

While many German companies have adjusted their earnings forecasts to account for rising energy as a result of the war in Ukraine, some of the country's core industries say they will not be able to operate without sufficient gas supplies.

Some argue that substantial sacrifices to preserve the way of life and freedoms are sometimes necessary. Moreover, prolonging the war in Ukraine is also costly for European economies. There are lots of hidden costs caused by the uncertainty. Rather than wait, some politicians are advocating for an immediate embargo of Russian energy and an increase in gas supplies from other countries; the substitution of electricity from coal or nuclear power for the gas-powered utilities; and a steady refilling of storage facilities over the summer. Still, everyone agrees that finding quick substitutes for Russian gas supplies will be a daunting task.

Meanwhile, German farmers association has called for a national reserve of fertilizer akin to those for gas and LNG. The headwinds facing farmers have left many wondering if they can weather the storm. Many need to make decisions now, but are unable to do so due to the current state of uncertainty surrounding input supplies and their higher and continued rising costs.

One leading German retailer have caught wide attention after announcing it is raising prices by up to 50% effective April 1, blaming rising production costs caused by the ongoing Ukrainian conflict. If a large German discount retailer cannot hold back the cost pressures, its highly probable that others will soon follow suit.

Argentina

The country has seen a surge in interest for its grain supplies recently. The head of a group representing Argentina's biggest grain processors and exporters reported receiving emails from French and Italian supermarkets seeking sunflower oil, as well as Egyptian and Lebanese government officials wanting long-term wheat and corn contracts.

Indian clients also are hoping to have Argentina cover the gap in soy and sunflower oil that used to be supplied by Ukraine.

The big question for countries like Argentina facing this fresh demand is whether they can deliver the goods. Demand for corn supplies is also very strong. According to the International Grain Council, Argentina recently quoted corn at $329 per ton, while Brazil offered $364 and the U.S. at $363 per ton. Some exporters are expecting prices to increase to $420-$430 per ton and are holding off selling now.

Like farmers elsewhere, Argentina's farm sector are anxiously in need of stocks of raw materials (including fertilizers) to help boost crop production going forward.

On March 22, 2022 Argentina's Central Bank (BCRA) raised its benchmark interest rate by 200 basis points to 44.5%. Using the authorities' preferred measure of the annual effective rate, which adjusts monthly compounding, the Leliq rate is closer to 55%. The effective rate is still only marginally above 12-month inflation expectations (53%), implying further tightening is on the cards.

It has become evident that monetary policy will need to be significantly more contractionary to prevent inflationary expectations from going adrift in Argentina. Recent data show that consumer prices rose 4.7% in February (taking inflation to 52%). The trend is concerning for several reasons. First, the rise in price levels is becoming increasingly generalized; monthly inflation closely tracked headline inflation, coming in at 4.5% in February. Second, the uptick in inflation came despite real peso appreciation and a contraction of the monetary base during the month. Third, the February result does not reflect the spike in international food and fuel prices since Russia's invasion of Ukraine. As the global commodity price spike feeds through more fully to domestic prices, Argentina's inflation will only accelerate further.

Recognizing the severity of the problem, in mid-March Argentina's President Alberto Fernandez declared a "war against inflation". However, Mr. Fernandez failed to outline specific measures that would have a significant impact on price pressures. The government has, so far, largely returned to tried-and-failed price controls.

Meanwhile, fiscal consolidation, as outlined by the just concluded IMF accord with Argentina – will be slow. The onus of dampening inflationary pressures will fall mostly on the central bank via more interest rates hikes. This reflects a lack of better policy alternatives and the need to keep the benchmark Leliq rate positive in real terms under the terms of the IMF program. We are likely to see revised forecasts showing higher inflation and more aggressive monetary tightening during 2022. Sharp interest rate hikes will weigh heavily on the economic outlook - but will be needed to prevent an even more damaging inflationary spiral.

As expected the Argentine Congress approved – with the support of a large majority of lawmakers – legislation enabling the government to enter into a new 30-month $45 billion extended fund facility (EFF) program with the IMF. The new program is expected to be approved by the IMF's executive board, paving the way for the Argentine government to receive fresh funding. However, the administration of Alberto Fernandez will face significant political challenges in keeping the IMF program on track. The government will have little option but to reach out across the aisle, not only because of its minority position in congress, but also because of resistance to the EFF from within the ruling party's own ranks. This will inevitably stoke tensions with various groups, including left-wing hardliners within the ruling coalition, Argentina's powerful governors, influential trade union leaders, social groups and even the local media [all of whom remain suspicious of and resistant to IMF conditionalities which governs the agreement]. Therefore, the IMF deal will provide the government with little reprieve on the political fronts; and economic imbalances will force the government to make difficult policy choices.

Businesses should prepare for the possibility that a newly agreed EFF program could quickly veer off course because of weak political commitment to economic orthodoxy. Failure to keep the IMF program on track will likely lead to a continuation of the vicious cycle of inflation, devaluation and possibly recession in Argentina – as experienced in recent years. At the heart of the country's perennial inflation problem is its unsustainable fiscal policy. Faced with extremely limited access to private-sector financing, the government has increasingly relied on the central bank to finance its large fiscal deficit. However, constant money printing has proven to be highly inflationary.

Under the auspices of the IMF the government is targeting a sharp reduction in monetary financing, taking it from 4% of GDP in 2021 to 1% in 2022 and 0.6% in 2023. The Argentine government's plan to narrow the fiscal deficit and pare back monetary emission depends in large part on its ability to reduce its subsidies burden. Last year, energy and transportation subsidies combined accounted for 3.2% of GDP. However, the recent spike in global energy and commodity prices will significantly complicate the government's ability to unwind these costly subsidies. Unless the government is able to plug its fiscal gap through revenue-raising measures or via spending cuts in other areas, it will have no option but to continue monetary monetization. This would be highly damaging for inflation expectations and would raise the risk of a wage-price spiral. Higher inflation would also mean that the central bank would have to allow for a relatively rapid rate of currency weakening (which will in turn, pass through to prices). Against this backdrop, there is a high risk that Argentina will enter into a new inflationary spiral that persists through 2022-23.

There is a real risk that onerous import restrictions could be reinstated. The government has indicated that its development policies will, in part, be aimed at protecting domestic industry from foreign competition via import substitution policies.

Given the current urgency of avoiding a food crisis due to lack of wheat, soybeans and corn due to the war in Ukraine, countries like Argentina [U.S. Canada and Brazil] could play an important role by beefing up production and lifting exports. The EU has authorized imports of corn, sunflower seed and sunflower cake from Argentina and the U.S.

The Buenos Aires grain exchange has cut its crops estimate for this year to 49 million tons to 51 million tons due to lack of rainfall that hit the country's crop earlier in the season. Argentina is the world's second exporter of corn, the top supplier of soy oil and soymeal, and a major supplier of wheat and sunflower oil.

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