Major Country Risk Developments
March 2022

By Byron Shoulton

Overview

Global GDP projections for 2022 are being cut in the wake of the Russia/Ukraine war as elevated crude oil, natural gas and commodity prices will in all likelihood be with us for some time. Heightened concerns about energy stability, supply chain disruptions and the potential for crippling cyber-attacks -including on infrastructure- will also weigh on global economies, stock markets, and on business and consumer confidence.

With the reappearance of war in Europe, toddlers sheltering in subway tunnels, the elderly fleeing on foot, nuclear power plants under threat, and millions of refugees crossing borders – together these images show that the post-cold war era and internationalism is under attack; and the struggle against authoritarianism is at a new stage.

A new study released recently, concluded that liberal democracies have been disappearing. The last 30 years of democratic advances are now eradicated, the report says. The numbers peaked in 2012 with 42 countries, and today there are 34, home to only 13% of the world's population. In many of those, "toxic polarization" is on the rise, according to the V-Dem study, a non-profit that studies governments.

The democratic decline is especially evident in Asia-Pacific, Eastern Europe and Central Asia, as well as in parts of Latin America and the Caribbean. The increasing number of closed autocracies- up from 25 to 30 countries with 26% of the world's population- contributes to the changing nature of autocratic rule.

For Ukraine and its democratically elected government, the prospects for survival look especially dim. Sanctions, the preferred weapon of the anti-Putin coalition, have a long history of failing to alter the behavior of rogue states or leaders. Ukraine may be just the first of several tests for the "old-world" order. The Chinese leadership recently reiterated that "reunification" with Taiwan – another democracy living in the shadow of an authoritarian neighbor – "must be fulfilled."

With uncertainty over its energy and raw material exports, together with sweeping economic sanctions, Russia now appears on its way to isolation from markets in the U.S., the European Union and in countries allied with them. They have imposed unprecedented sanctions on Russia. Big Russian banks were expelled from the global payments system, and Western firms were banned from dealing with them. Russia's central bank was barred from tapping most of its $630 billion in foreign reserves. The Russian currency crashed, and the central bank doubled its main interest rate to 20%. Sanctions were also imposed on Russian oligarchs close to the Russian president.

A technical default on Russian sovereign dollar debt could begin when a coupon on dollar bonds falls due in mid-March. That would deepen the pain for foreign investors that helped finance the Russian government. Russian government debt remains low by international standards. Some $39 billion of dollar-denominated bonds are currently outstanding. If payments worth $107 million due on March 16, 2022 are missed, Russia then has a 30-day grace period in which to make payment. Russian government dollar-denominated bonds issued after 2018 have fallback clauses that allow payment in rubles. But creditors may not be able to accept those payments. The world's big banks and clearing houses are closing their doors to Russian business. Government dollar bonds due to be repaid in April are trading at 20 cents on the dollar. One-year credit default swap (CDS) prices suggest a 70% probability of default (as of March 7, 2022). The payout for CDS holders is unclear. If default occurs, bonds typically would be auctioned to establish fair value. But prices would reflect sanctions as much as Russian creditworthiness – or lack of it.

Some Russian businesses may be better placed to pay some foreign creditors, depending on the nature of sanctions against them. They may be able to make dollar repayments from funds held abroad. Rosneft and Gazprom (Russian oil & gas giants) have reportedly around $3.3 billion of Eurobond principal payments due in March 2022. Reports are that the gas company could make those payments via a Luxembourg-based special purpose vehicle. No foreign investor should count on such payments if they are based in a country engaged in the economic war against Russia. Many have contemplated that given the uncertainties, is prudent to assume these (losses) will have to be written off.

While the west pursues sanctions against some Russian banks, it excluded Russia's third-largest lender, Gazprombank, which serves the energy company Gazprom. At first, all attempts were made to exclude Russia's energy sector from sanctions. However, the market including commodity traders, banks, insurers and shippers independently retreated from trading, financing, insuring or shipping Russian oil once the war against Ukraine began. Some of the biggest buyers of Russian crude cancelled shipments and orders as companies and financial institutions shun Russian oil business. An estimated two-thirds of crude buyers appear to be boycotting Russia, - a formal embargo would have a limited immediate impact while still creating market concern and will drive oil prices higher [already at eight-year highs] for consumers around the globe.

Even without sanctions, the lack of buyers for Russian crude could force Russian producers to cut production once storage sites were full. That would have devastating consequences for Russian production capacity; and shuttered oil wells can be difficult to turn back on.

An unusual display of unity among western allies including Germany, UK, Canada, US, Japan, France, Switzerland, depriving some Russian banks of access to Swift, international organizations banning Russian athletes, and companies refusing to trade Russian oil - send a strong message that countries and peoples around the world now regard Russia as a pariah state. The unprovoked war on Ukraine has become a watershed moment: evoking sentiments not seen since the end of World War II, and shattering hopes of peace which followed the break-up of the Soviet Union. The situation in which Russia now finds itself is one of isolation- for one of the world's most powerful nuclear powers. Such isolation puts Russia in an untenable position and places the world on a dangerous path.

No one could have predicted prior to the start of this war that Germany would reverse decades of military hesitancy and approve a 100 billion euros defense budget. Neither was it ever foreseen that Switzerland would freeze Russian assets in its banking system; or that You Tube, World Cup Soccer and global energy companies would cut ties with Russia for its aggression.

Costly fuel coupled with the need to fly longer routes will hurt airlines as higher transport costs hit household budgets. Just as aviation began soaring away from the pandemic, the war in Ukraine is dealing a blow to the sector's recovery by way of higher costs for crude, with the prospect of a possible embargo on Russian oil exports. Global oil prices have risen nearly two-thirds since the start of the year. Shares in airlines are being hit.

Aviation is the most oil-intensive sector, shipping is close behind, followed by the chemicals industry. Fuel accounts for 25%-40% of airline operating costs. Many airlines have hedges in place. But pricier fuel and the need to fly longer routes to avoid Russian and Ukrainian airspace will hurt airlines. Moreover, commercial aviation cannot usually rely on passing on extra costs on to customers.

Countries importing more expensive fuel have populations that are anxious to travel but are also constrained by a jump in their cost of living. Some countries are extending financing to their flag carriers to hold ticket prices down.

Other transport companies will be hit as well. Fuel represents 10%-15% of bus companies costs, though demand for public transport should increase as travelers are priced out of using their cars. Logistics companies will be in the spotlight, though the typical "costs plus margin" contracts should allow them to pass on some higher fuel expenses.

For some developed economies, the situation is less bleak than during previous oil price spikes. A shift to services and greater energy efficiencies have reduced intensity- total energy consumption per unit of GDP – is reported to have fallen by a third globally since 1990. Nonetheless, higher transport costs will ensure the effect of expensive crude will be felt across economies and sectors. Household budgets will be stretched, and business profits will get squeezed. With sustained oil price rises, the pain will be widely shared around the world.

USA

The U.S. trade deficit hit a record $89.7 billion in January. The foreign-trade gap in goods and services rose 9.4% from the prior month. Imports were up and exports were down. Prior to Russia's attack on Ukraine, U.S. households were already experiencing strains from rising prices. Since the war began oil prices went from $93.75 per barrel to $147 and continue to rise. U.S. natural gas prices increased from $4.62 per thermal unit before the war to $6.

Among other commodities, wheat, which 30% of global supplies is jointly provided by Russia and Ukraine, is trading at 14-year highs of above $14 per bushel after rising 68% so far in 2022. Corn is at 12-year highs of over $8 per bushel. The U.S. trade deficit will likely worsen as the year progresses.

The U.S. dollar should remain strong via safe haven inflows into U.S. assets, a favorable U.S. interest rate differential and a relatively better U.S. economic outlook. A stronger dollar tightens U.S. financial conditions, but also make imports cheaper for U.S. companies, which could help counter strong inflationary pressures.

U.S. job growth accelerated in February, as falling covid cases brought customers back to businesses and workers back to the office. Employers added 678,000 jobs in February bringing unemployment down to 3.8%. While it is true that the U.S. is less vulnerable than Europe to the economic effects of the Ukraine crisis, a prolonged conflict will have global repercussions that are hard to predict.

U.S. job openings remain at record highs, while lay-offs are at an all-time low. The U.S. labor market has been resilient during this recovery, but many companies continue to report trouble attracting workers – a challenge that could become more difficult if workers are expected to show up in person. Surveys continue to indicate that many workers are reluctant to do "in person" work when there are options available for remote work. The competition for labor has pushed up wages – good news for employees, but a concern for the Federal Reserve which is already concerned with high inflation.

The consensus is that the Fed will raise rates in March by 25 basis points, with four additional rate increases likely over the course of 2022. The ongoing war in Ukraine, sanctions on Russia - will keep prices for oil, metals, grain and other commodities elevated in the months ahead. Rents and home prices remain elevated and are still increasing in some cities. This is certain to add to already high inflation across sectors, clouding the U.S. economic outlook for 2022. The new level of uncertainty, combined with private businesses leaving Russia, are likely to cause a decline in investment and spending. Taken together, these trends are worrisome and suggest weak economic growth this year and the possibility of a drift toward recession in 2023.

China

For years China has been strengthening its economic ties with countries around the world. Chinese leaders have been thrilled by the contrast with their apparent competence compared to growing evidence of disunity and disorganization among western allies. The scenario seemed ripe for a new international order in which China would compete with the U.S. for supremacy. That scenario still seems likely, but Russia's invasion of Ukraine has complicated China's plans. It has unified much of the rest of the world-including the U.S., the EU, Britain and Japan – in support of Ukraine, with a swiftness and unity that was lacking in recent years.

China's leadership, on the other hand, find themselves in partnership with the world's new villain, the Russian president. First, China assured Russia that it would buy Russian wheat exports that face global sanctions. However, China's quest to lead and influence the world order benefits from international stability. The ongoing war in Ukraine has disrupted global stability, prompting Beijing to plead for an end to the aggression while calling for respecting other countries' territorial integrity. China even voiced concerns for civilian casualties. This amounts to a nuanced change in stance for China which pledged support for and unity with Russia just prior to the latter's invasion of Ukraine.

On top of China's ongoing real estate crisis and weak consumption recovery, the country just released GDP growth target for 2022 of 5.5%, its lowest in three decades. This follows year-on-year growth of 4% in Q4 of 2021. Beijing is seeking to buttress its economy after a sharp loss of momentum in 2021 and fallout from Russia's invasion of Ukraine. The 5.5% target reflects lower growth expectations in 2022 compared with pre-pandemic rates, as Beijing maintains its strict covid measures, enforces its "common prosperity" policy to reduce inequality - while boosting the Communist Party's control over business. The CCP continues to contend with the debt-fueled real estate crisis.

China's leadership acknowledged that to achieve the 5.5% growth goal this year -in the evolving dynamics at home and abroad- it will encounter many more risks and challenges. The new budget includes sharp increases in defense spending, up 7.1% to $230 billion - its fastest pace in three years - as China accelerates the modernization of its armed forces while the U.S. strengthens its military presence in the Asia-Pacific.

Still, the announced 2022 growth target is higher than forecasts released before the outbreak of the Ukraine war, which is expected to drag on global growth and to sting Chinese exporters. Private Asian forecasters view the announced Chinese growth target as ambitious - given current external challenges. This marks the first time since 1991 that China's GDP growth target has been set below 6%. Still, the Chinese economy has outperformed much of Asia in recovering from the pandemic.

Economic stability is paramount in China, especially ahead of a historic party congress due later this year, when President Xi [the country's most powerful leader since Mao], is expected to begin an unprecedented third term as president. Last year China targeted GDP growth above 6% and recorded 8.1%, owing to the weak performance in 2020 when much of the country was under lockdown for months. The Chinese economy bounced back from the early impact of the pandemic, supported by industrial rebound and strong exports. But the economy has struggled to maintain momentum, with the real estate sector under severe debt distress and consumer spending remaining sluggish. Beijing's focus appears to be shifting toward policy easing and allowing credit expansion after the authorities signaled fiscal and monetary policy would be relaxed late last year. This will include directives at the level of business in the banking system - to benefit the market and address corporate needs.

Economic stability will be tested this year as Beijing continues to deleverage China's burdened real estate sector, which accounts for about a third of economic activity; and has been hit by a series of defaults among developers. Some warn that China will need to undertake fundamental reforms to overcome systematic risks from high levels of local government and real estate debt, as well as its aging society. This will be a delicate balancing act. Chinese leaders know that the economy cannot rely on infrastructure investment or real estate investment forever. Shifting the growth model will matter the most.

No doubt, western withdrawal from Russia provides lucrative opportunities for Chinese companies to step in and fill the gap. Such a development over time would strengthen the ties between both countries, potentially posing a formidable alliance against the west.

Meanwhile, the China-based Asian Infrastructure Investment Bank [AIIB] has suspended all current and pending business relating to Russia and Belarus following the outbreak of the war in Ukraine. The decision could cause some strain in ties with China and Russia, which are close trading partners but whose relationship has come under scrutiny following Russia's military aggression in Ukraine. China is the AIIB largest shareholder with 26% of its shares.

AIIB made its investment in Russia in 2019 with a $500 million loan to fund a transport and infrastructure project. In 2021 it approved a project for 115 million euros to fund improvements in the Belarus healthcare system. That decision was criticized by NGO's in the country due to a political crisis under the regime of Alexander Lukashenko – who allowed Belarus as one of Russia's launching pads for the invasion of Ukraine.

Alongside contributions from its members, AIIB- which has $100 billion of capital stock – has raised cash through the bond market and has four bonds outstanding denominated in rubles that have all collapsed in value since the war began. The bank's bond maturing in 2025 fell from 80 cents on the dollar to below 50 cents in a week.

UAE

The global financial crimes watchdog, Paris-based Financial Action Task Force (FATF) has put the UAE on a list of nations "subject to increased monitoring", putting the UAE on a list of 22 other nations including Syria, Albania, Panama and South Sudan. FATF said the UAE had made a high-level commitment to work with the watchdog on anti-money laundering and counter-terrorism financing and had made "significant improvements" to improve its systems.

Being on the watchlist will hurt the UAE's reputation, which has long prided itself as the destination of choice for international banks and multinationals operating in the Middle East. The UAE, and Dubai have long garnered a reputation for the ease of moving large sums of cash in and out of the nation and lax scrutiny in sectors such as real estate deals.

Inclusion on the FATF's watchlist is not expected to deter financial institutions looking to set up in the UAE. But the reputational damage could raise costs for local banks doing business with global counterparts and complicate compliance issues for international lenders. In 2020 the FAFT said the UAE's limited number of money laundering prosecutions, especially in Dubai, were a "concern" and urged the country to strengthen its anti-money laundering measures.

Ahead of the release of the report, Emirati officials said the UAE had taken many steps to address concerns and had significantly increased the authority's ability to clampdown on flows of questionable funds in all seven emirates of the federation. This has included creating a register of corporate beneficial ownership that can supply requested information to international counterparties in three days. The UAE has also signed extradition treaty agreements with 33 countries including China, India and the UK.

Sectors prone to financial abuse, such as real estate, have been brought under the umbrella of the federally managed anti-money laundering reporting system.

Since the report was made public, UAE's office of Anti-Money Laundering and Countering Financing of Terrorism reminded all that it takes its role in protecting the integrity of the global financial system extremely seriously. It pledged to work closely with the FATF to quickly remedy the identified areas for improvement.

Brazil

The reverberations of the Russia-Ukraine war are already being felt across the world-in commodity markets, financial markets and supply chains. These developments will have important ramifications for Latin America's economy this year. The crisis is contributing toward driving international prices of both hard and soft commodities to new highs, while also raising risks of a flight to safety that generates capital flight from emerging markets while exerting depreciation pressures on LATAM currencies. These factors will aggravate price pressures in a region that has struggled to keep inflation at bay.

There will be opportunities amid the crisis. One is that LATAM's commodity producers will benefit from higher fiscal and external revenue. Another is that regional businesses may be able to use global supply-chain disruptions as leverage to expand their footprint in overseas markets. The crisis will exert strong upward pressure on food prices, as both Russia and Ukraine are among the world's largest exporters of food grains-notably wheat and corn-as well as fertilizers.

Meanwhile, the price of sunflower seed oil is on track to reach record highs, given that Russia and Ukraine combined account for more than 75% of the world's sunflower seed oil exports. This is in turn lifting prices for palm and soy oil, which are relatively good substitutes. In addition, an ongoing spike in prices of base metals is likely to feed through into higher prices for industrial goods and consumer durables.

Brazil is the largest producer of coffee, soybeans and sugar, and the most dependent of the world's agricultural powerhouses on imported fertilizer. Brazil imports 85% of its fertilizer and about a fifth of thoseimports are from Russia.

Russia's trade ministry has called for a broad suspension of fertilizer exports according to news reports. The Brazilian president recently acknowledged how important fertilizer imports were to his country, calling them sacred and explaining his need to maintain cordial relations with Russia. If Brazilian farmers have to pay significantly more for fertilizer or are unable to produce as many crops, the cost of its agricultural products is likely to climb even higher, driving up food prices around the world. Brazil is also an important supplier of corn and beef. Higher grain prices increase animal-feed costs, which are passed on to consumers, who will have to pay more for meat and other animal products around the world.

Current Brazilian stocks of fertilizers are expected to last over the next three months. Before the Ukraine war, farmers worldwide were struggling to buy enough fertilizers, some of which have more than doubled in price last year. Higher natural-gas prices hampered production of ammonia needed for nitrogen fertilizers, while power outages at Chinese fertilizer plants and hurricane Ida in the U.S. curtailed global production.

War in Ukraine and sanctions on Russia have made the situation worse, raising the prospect of a prolonged global supply crunch that would further stoke inflation and hunger among the world's poor. Russia which accounts for about two-thirds of the world's ammonium nitrate production has halted exports until April to guarantee supplies for farmers at home. Higher natural-gas prices have also pushed up prices for the product, which is used to increase the yields of crops such as corn and wheat.

Brazilian farmers are unsure what the immediate future will bring. The war brings uncertainty, and the cost of agricultural production becomes a big unknown. Plans are afoot to secure supplies from Canada. Canada is the world's largest producer of potash fertilizers, followed by Russia and Belarus.

The Brazilian fertilizer association has warned that local fertilizer stocks will only last for another three months. Sanctions and travel restrictions have hampered shipments to Brazil. The government is encouraging new investment in potash and phosphorus mines, but analysts warn these will take years before farmers would benefit. Sluggish productivity has kept Brazil from developing a bigger domestic fertilizer industry.

Global food prices were already at 10-year highs before the Russian war in Ukraine – covid hampered shipments and heavy rains in some growing regions curtailed production. That is translating to higher prices for a wide number of grains and food stocks.
Policymaking is becoming more unpredictable and populist as the October 2022 elections approach, meaning that fiscal policy could become even more expansionary this year. Already, many structural reforms are being delayed and left to the government that will take office in 2023. These include measures to reduce the public-sector wage bill and comprehensive reform to simplify the tax system by unifying several federal, state and municipal consumption taxes into a single value-added tax (VAT).

After rebounding to pre-pandemic levels in early 2021, fueled by fiscal and monetary stimulus, the economic recovery has petered out, and there are several obstacles ahead, including the October general elections and the war in Ukraine that could interrupt fertilizer shipments from Russia. A resurgence in inflation (to 10.5% in January) – whipped up a perfect storm of supply disruptions (which continue to hit industrial chains globally), higher food and energy prices, and currency weakness-has triggered sharp interest rate tightening. Higher social spending will have a net negative effect owing to the impact on financial conditions as markets fret about associated risks, both fiscal and political. Economic reopening continues, as vaccine rollout is now well advanced, helping services to recover more fully.

The real (currency) has appreciated in 2022 as foreign investors sought out undervalued, commodity-exporting markets. By some measures the real is still undervalued, and there remains room for appreciation later (2022-26). In the near term, however, U.S. monetary tightening and domestic election-related volatility will weaken the currency.

Risks to Brazil's external position are being balanced by the country's structural trade surplus and modest external debt ratio, a relatively comfortable reserves cushion, and a currency that is no longer overvalued by higher interest rates, as in the past. Public external debt is low, and most Brazilian companies have some sort of currency hedge, despite generally moderate private external debt. Exports of agricultural goods and iron ore to China and other countries will keep the trade account in surplus in 2022-23, but the surplus is expected to decline gradually as imports rise following recession-related compression in 2020. Brazil's current-account position is forecast to deteriorate, with the deficit widening to 4% of GDP in 2025-26.

However, inflows of foreign direct investment will match this, reflecting sizeable market opportunities. Inward direct investment increased by 35.4% year-on-year in January as the economy recovered, and foreign companies reinvested more in Brazil. This is a positive development as the figures reveal a surge in net portfolio investments, with inflows of $4.8 billion, as some global investors see Brazilian assets [which were hit hard in 2021] as an opportunity.

Brazil will remain one of the battlegrounds in U.S.-China rivalry. Anti-Chinese rhetoric in Brazil has stirred bilateral tensions, but pragmatic figures are encouraging Chinese acquisition of assets, as Brazil needs investments in infrastructure and energy projects, as well as Chinese imports of Brazilian raw materials and agricultural goods. A Lula government if elected, it is believed, would bring warmer relations with most countries, and particularly the EU, based on anticipated stronger environmental policies.

Guyana

The Guyanese government is planning on pushing for more favorable terms with foreign energy companies in the months ahead; and maintaining broadly market-friendly policies designed to incentivize foreign investment. The current global energy situation put the Guyanese negotiators in a stronger bargaining position.

Booming public revenues will allow the Guyanese government to increase public spending and public investment in the years ahead, helping to broaden the economic recovery from the pandemic to the non-oil sector. The expectation is that the government will try to balance its push to secure higher revenues from oil production with policies to attract private investment in the year ahead.

The sitting government which took office in August 2020, had previously campaigned on improving Guyana's royalty rates with ExxonMobil and other energy companies. The ruling Peoples Progressive Party blamed then-President David Granger for negotiating unfavorable terms with ExxonMobil after the company first discovered oil in 2015. However, since taking office, the current administration has softened its position, instead vowing to improve the government's terms in negotiations over future royalty agreements. The government stressed that talks over future profit-sharing agreements would secure higher royalty rates and strengthen environmental regulations as companies increased crude production in the offshore Stabroek block, where ExxonMobil and its consortium partners announced a 21st discovery in October 2021.

The government is seeking private capital to finance the development of a gas-fired power plant this year, along with a 220 kilometers undersea gas pipeline, projects that would boost domestic power generation capacity and reduce the country's reliance on imported fuels. Foreign financing was sought at Expo 2020 Dubai in October last year by Guyana's prime minister and finance minister. With that in mind, the government is choosing to promote market-friendly policies, rather than taking a hardline stance with oil companies already operating in the country that could risk future energy contracts and potential investments.

Meanwhile Guyana's long-running territorial dispute with Venezuela over claims to the Essequibo region of the country, remain unresolved and is viewed as a potential external threat. It is considered unlikely that Venezuela will use military force to pressure Guyana over these claims and the U.S. sent Admiral Craig Faller to Guyana in January 2021 to announce a deeper bilateral strategic partnership with the country. Guyanese officials have cited Venezuelan rhetoric as a threat to investment and to its territorial sovereignty and have asked the International Court of Justice to formally rule on the issue to help assuage investor concerns.

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