

Major Country Risk Developments June 2024



By Byron Shoulton

Overview

The public mood in advanced countries remains low as the cost-of-living crisis keeps households under pressure. Consumer confidence has not returned to pre-pandemic levels, suggesting that households are still feeling the pain of the cost-of-living crisis despite an economic rebound in many countries. According to the Organization for Economic Co-operation and Development (“OECD”), the public mood across advanced economies in May was 1.6% lower than in the same month in 2019. In the U.S., consumer confidence was 2.3% lower while in the Eurozone, it was down 2.2%. Over the past four years, consumer confidence has dropped sharply during the pandemic, rebounded strongly when economies reopened, then fell again as inflation hit a multi-decade high in many countries. The public mood is now show-

ing some improvement from last year’s depths, rising 1.2% year-on-year in April across OECD countries. That comes as the UK and Eurozone economies both returned to growth this year, while U.S. growth slowed in the first quarter, but the economy has been expanding since 2022.

However, consumer confidence remains below its long-term average in most advanced economies, posing a headache for politicians campaigning in elections around the world this year. Confidence is low because households are still under pressure despite the growth returning to their economies. A large chunk of the global population saw a significant squeeze on real earnings, and this has not been fully reversed. The global economy





appears to be in a sluggish momentum where consumers lost a lot of purchasing power, while there are rising geopolitical tensions and governments lack money to spend.

Overall, wages have not kept up with inflation and were still below their levels at the end of 2019, in the third quarter of 2023 in 20 of the 35 OECD countries, including Germany, Italy and Spain. Although inflation is easing, prices are sharply higher than they were a few years ago, and consumers have not adjusted to this new reality. Repeated unexpected shocks, ranging from the pandemic, the cost-of-living crisis, high geopolitical tensions, and trade relations deteriorating between the U.S. and China, means there is apprehension about future economic prospects and personal finances. The negative mood among consumers creates a challenging backdrop for the EU parliament elections, UK general election and the U.S. presidential election, where the health of the economy is a focus of the campaign.

The hit to households from high prices is reflected in weak consumption which has stagnated over the past four years across the Eurozone and in the UK, where the lack of growth compares to that experienced during the financial crisis. Real household consumption was up barely 1% at the end of 2023 compared with the final quarter of 2019, contrasting with a rise of more than 6% in the four years before that.

The other factor keeping consumer morale low is tighter monetary policy than before the pandemic. Mortgage rates are down from peaks reached in 2023 but remain much higher than three years ago in the U.S., UK and the Eurozone. Rents are also elevated, hitting disposable income.

The U.S. has enjoyed much stronger economic growth than Europe since the pandemic, helped by a lower hit from energy and food prices. However, the University of Michigan consumer sentiment index plunged to a six-month low of 67.4 in May, with respondents expressing worries that inflation, unemployment, and interest rates

were moving in an unfavorable direction. The expectation is for U.S. GDP growth to remain stronger than in Europe. The 2024 U.S. GDP growth is projected at 2.4% compared with 0.5% and 0.6% in the Eurozone and UK, respectively.

Meanwhile, Chinese investments across eastern Europe, north Africa and central Asia have far outpaced those from the U.S., as China seek ways to circumvent U.S. trade sanctions. In 2023 the 36 countries in which the European Bank for Reconstruction and Development (“EBRD”) operates- ranging from Poland in the east and from Morocco to Turkey in the south- received 39% of their combined greenfield investments from China, up from 5.1% in 2022 and only 0.6% 20 years ago.

According to the EBRD, China is dwarfing foreign direct investment from the U.S. and Germany. Together, the U.S. and Germany each accounted for just 8% of greenfield foreign direct investment in the regions covered by the EBRD. China’s surge in part shows how the country has tried to diversify production locations in terms of potential trade benefits. For example, China is spearheading investments in Morocco, which has a free trade agreement with the U.S. and can export raw materials for electric vehicles without being subject to punitive tariffs and instead be eligible for U.S. renewable energy subsidies. CNGR Advanced Material, a Chinese battery components manufacturer, signed an agreement last year to a build cathode materials plant in Morocco to supply the U.S. and European markets. With this kind of investment, China hopes to tap into the long reach of U.S. subsidies.

Recently, the U.S. announced significant tariff increases on imports from China, including electric vehicles, batteries, and semiconductors, to protect U.S. jobs. The European Union (“EU”) is considering erecting similar barriers. However, some European policymakers have highlighted the potential for Europe to attract Chinese manufacturers rather than blocking them altogether. They cite the U.S. enticing of Japanese carmakers in the

1980's to open plants in America. This strategy would help create jobs and ensure that the EU remains a manufacturing base.

China's FDI lags behind the U.S. and Germany in the EU's central and eastern member states, as Brussels has taken a more forceful approach against Chinese companies that are subsidized by Beijing and compete at lower prices on the internal market.

The EBRD expects GDP across its regions to average 3% in 2024 and 3.6% in 2025, up from 2.5% in 2023. The countries that the EBRD operates in struggled to bring down inflation which surged during the pandemic and after Russia's full-scale invasion of Ukraine in 2022. While the pace of disinflation has been somewhat quicker than expected a year ago, inflation is still about two percentage points above pre-pandemic levels.

The EBRD lowered its GDP forecast by 0.2 percentage points from its previous projection – in part due to weakening growth in Central Europe and the Baltic states, which are suffering from the impact of the war in Ukraine and Germany's economy slowing down. Countries continues to be hampered by a rise in borrowing costs over the past two years, in contrast to other regions where the risk premium has fallen back to the levels before Russia's invasion.

China & Russia

In May, China and Russia vowed to work together against what their leaders described as "destructive and hostile" U.S. pressure. The two allies agreed at a summit to deepen their ties which has allowed Russia to sustain its invasion of Ukraine.

Both countries pledged to tighten ties between their militaries and to expand the scale of their joint exercises. They also vowed to deepen their economic partnership, which has emerged as a vital lifeline sustaining Russia after western sanctions over Ukraine attempted to cut



Russia out of global markets and supply chains.

While China and Russia recorded a huge increase in trade following the outbreak of the Ukraine war, there are signs Beijing may have pulled back slightly after the U.S. warned it could target Chinese companies found to have helped fund the Kremlin's war machine. China's exports to Russia fell in March and April as the U.S. threatened to target Chinese banks it alleged were helping circumvent sanctions. China has supplied the Russian economy with a wide range of electronics, tractors, and even washing machines. It has become the critical source of optics, microelectronics, drone engines, and other materials that enables Russian weapons production, while Russian arms exports to China have fallen precipitously. Meanwhile, with Russian oil and gas now shunned in Europe, it has had to sell at significant discounts to China. Beijing is yet to agree on a major new gas pipeline, using its leverage to squeeze Russia on price.

The relationship is a strategic partnership where both sides need each other but it is increasingly asymmetrical in China's favor. China is not only the more powerful partner, but also the one that has many more options than Russia and the Ukraine war has exacerbated that. Bilateral trade reached a record \$240 billion in 2023, up 26% from a year earlier. However, that is dwarfed by Chi-

na's trade with the EU at \$800 billion and with the U.S. at \$660 billion.



Around 60% of newly sold cars in Russia were Chinese at the end of last year, almost double their share in 2022. Russia's Auto VAZ, the maker of Lada cars, has noted that Chinese carmakers are crowding out Lada by offering large discounts. Other Chinese brands are aggressively expanding into the Russian market.

Norilsk Nickel, a Russian metals giant, will shift a portion of its copper smelting operations to China after sanctions hindered access to crucial equipment and impacted the company's payments. There are growing concerns in Moscow about Russia's dependence on China. However, under the current circumstances for Russia, growing dependence on China is effectively the only alternative to isolation, which Russia is seeking to avoid at all costs. China buys billions of dollars of Russian energy exports, mostly at discounts.

China also holds most of the cards in energy. After the Ukraine invasion severed decades-old oil and gas links between Russia and Europe, China stepped in as a willing buyer. China has also supplied much-needed parts

for Russia's oil and gas industry that used to come from the West. That means China has commanded discounts. Russian ESPO blend oil delivered to China currently trades at \$5 cheaper per barrel than other comparable crude deliveries to China.

So far, Beijing has been reluctant to sign up for the Power of Serbia 2 gas pipeline. This is a massive project that would carry gas from the Yamal region in northern Russia to China via Mongolia, the pipeline has become critical for Russia ever since its traditional European market shrunk in the wake of Russia's invasion of Ukraine. Sticking points such as financing and gas pricing remain unresolved, industry watchers say. China, which can tap other suppliers such as Australia and Qatar, can afford to wait it out and then force lower prices from Russia.

Despite the escalating imbalance, the bond between these two nuclear-armed powers carries profound implications for the West. Those include intensifying military collaboration and heightening geopolitical rivalry with the West across Africa and Asia. The surge in their oil and gas trade is meanwhile fundamentally reshaping the global energy map.

Worries are also growing among Western officials that, as China provides the essential function of backfilling the Russia's war economy, Moscow could win against Ukraine in a war of attrition. Meanwhile, Europe and the U.S. struggle to mobilize their own defense industries to match Russian production. Both U.S. and European leaders have pushed the Chinese leadership to cut back on China's support for Russia's defense industry. The U.S. has indicated a willingness to act against Chinese banks handling trade in so-called dual use goods that have both civilian and military application. This may explain the recent slight moderation noted in Chinese exports to Russia. There is only one caution: like with previous sanctions on Russia, companies would switch to other banks and use middlemen, including third countries.

Though historically the relations between the two countries have oscillated between periods of mutual support,

ideological competition and even outright hostility, Moscow and Beijing have long viewed the U.S. as their main challenger and sought to undermine its global influence. For China, if the U.S. is seen to “lose” the Ukraine war, it will further dilute U.S. global influence.

Indeed, the dollar’s dominance in global trade remained the most difficult issue for China’s immediate hopes of thwarting U.S. influence.

USA

The U.S. housing market is showing early signs of normalization according to Fitch. However, the market is also impacted by high mortgage rates and escalating prices. Homes in 90% of major metropolitan areas in the U.S. are considered overvalued, with the sharpest increases recorded in Southern states.

Fitch reported that homes were overvalued nationally by 11.2% at the end of 2023. While a recent increase in the number of home listings in some markets is promis-

ing – suggesting that the U.S. housing market is showing early signs of normalization, the pace is being tempered by persistently high mortgage rates and the escalation of home prices. The 30-year mortgage rate averaged 7.09% as of May 9, 2024. Some homes are selling for far over the asking prices with home-buying demand outpacing the number of available properties on the market.

In early June 2024, the Bank of Canada made its first interest rate cut since the pandemic. The U.S. Federal Reserve (“the Fed”) and Bank of England are making their own risk assessments and will deliver the results in the coming weeks.

Until recently, sturdy economic growth and a stop-start disinflation process had raised prospects that the Fed would delay rate cuts into next year. However, a run of data, including downbeat manufacturing outlook, and a resumption of the downward trend in core inflation has emboldened calls for a cautionary first cut. Nonetheless, the recent May jobs report surprised on the upside: 175,000 jobs were created but unemployment edged up to 4%.



Europe

Almost two years after its interest rate-raising cycle began, the European Central Bank made its first cut on June 6, 2024. The quarter-point drop from 4% to 3.75% will give European borrowers some relief. Since the pandemic, the fear has been that rising inflation would spiral higher if rates were not restrictive enough. Slowly the dynamics have shifted. Now, with inflation trending down and inching closer to 2% across advanced economies, the impact of the high cost of credit on economic activity is receiving more attention.

In the Eurozone, inflation has been gliding gently down towards 2% all year, with a slight hiccup in May. Forward-looking indicators appear promising. Surveys of business sales price expectations point to a weakening in core inflation components ahead, as do falling wages advertised on new job postings. Signs that the disinflation trend will continue, combined with eighteen months of weak quarterly economic growth, are a decent enough rationale to remove the top level of rate restriction.

Environmentalists warn that Europe's steel industry risks missing ambitious climate targets despite pledges of billions of euros in state aid from the region's governments. Since 2022, the European Commission ("EC") has agreed to more than eight billion euros in grants for some of the eurozone's largest steel producers to support investment in less carbon-intensive production. ArcelorMittal, the world's second-largest steel producer and Europe's biggest, has received 3 billion euros in commitments for decarbonization projects to phase out the use of coal in favor of natural gas and, eventually, hydrogen.

Thyssenkrupp, the German industrial conglomerate, received 2 billion euros in commitments, while other groups such as Salzgitter have received 1 billion euros. Tata Steel 500 million pounds sterling from the UK government as part of an agreement to invest 700 million pounds of its own funds. Despite these subsidies, climate research groups say Europe's steelmakers are still not on

track to meet science-based emissions reduction targets, enabling them to limit global warming.



With global demand for steel forecast to rise more than one-third over 2020 levels by 2050, industry analysts stress that the shift towards greener technologies needs to accelerate. Outside of power generation, the iron and steel sectors are the largest industrial producers of carbon dioxide. Steel alone accounts for 7%-9% of all direct fossil fuel emissions, according to the World Steel Association.

Estimates are that it will cost about \$1.4 trillion to decarbonize the global iron and steel industries by 2050. Most European steel groups are investing in electric arc furnaces, which melt down recycled steel and emit a fraction of the carbon dioxide of traditional blast furnaces, which use coke to produce pig iron, the smelting product, from iron ore. This is then refined to steel.

To get to net zero emissions, the industry is banking on using "direct reduced iron" ("DRI") plants in combination with electric arc furnaces. DRI plants use natural gas, and potentially green hydrogen, which at present is unavailable at scale, to extract pure iron from iron ore.

As well as being critical of the steelmakers' progress, climate campaigners complain about a lack of transparency, which makes it difficult to determine how much money is being spent on research and development of lower carbon alternatives.

Meanwhile, the European Commission has raided the offices of a Chinese security equipment supplier, deploying new anti-foreign subsidy powers in a move that will further inflame tensions between the trading superpowers. The raid by the EC and local law enforcement on the offices of Nuctech, which manufactures baggage security scanners, comes as Brussels cracks down on what it sees as Chinese unfair trading practices. The raids took place in the Polish and Netherlands offices of Nuctech, a Chinese state-owned company. The company's products have been banned by some western countries on national security grounds.

The U.S. has added Nuctech to the Commerce Department's entity list for "its involvement in activities contrary to the national security interests of the U.S." and warned that several countries have raised concerns about security risks posed by Nuctech equipment – given the company's control by the PRC government.



Nuctech baggage scanners have been installed in European airports. Members of the European parliament condemned a 2022 decision to purchase Nuctech scan-

ners for the Strasbourg airport. The company's scanners are also used at Rotterdam, Europe's largest port, for checks on containers, trucks, travelers' luggage, and parcels entering and leaving the EU.

The raids were the first time Brussels had used its anti-foreign subsidy rules to justify a move on a company. China is closely following the EU probes and warned that it would take all necessary measures to safeguard the legitimate rights and interests of Chinese enterprises. China said the investigation of Nuctech, and other recent anti-subsidy probes were "protectionist" acts that were being conducted in the name of fair competition. China's Commerce Ministry contends that the raids violate the principle of due process and highlights the further deterioration of the EU business environment.

The raids follow a spate of arrests in Germany of people suspected of spying for China, including three accused of trying to sell sensitive military technology to Beijing. The EU is China's second-largest trading partner and one of its most important sources of foreign investment. Tensions have been growing between China and the EU, with the latter launching several anti-subsidy investigations in recent months. The EU has accused China of stoking industrial overcapacity, especially in electric vehicles and renewable energy, which compete directly with European companies, with ongoing examples of massive dumping of these products in EC markets at discounted prices.

The EU also opened an investigation into China's medical device market on the grounds that European manufacturers were being unfairly blocked from supplying hospitals and doctors' offices. The EC said Chinese laws, including the "Buy China" policy, were favoring the procurement of domestic medical devices and services. If the EU determines there is discrimination, it can take measures to hinder China's access to the European markets.

Far-right political parties have made significant gains in EU elections, performing well in Germany, and comfort-

ably winning the vote in France, prompting the French president to call a snap parliamentary election. Early results suggest that the far-right and hard-right parties are on course to hold a quarter of the seats when the European parliament next sits, up from a fifth in 2019. However, parties of the center retained a majority in the parliament.

The results delivered a stinging blow to the domestic standing of President Macron in France and German Chancellor Olaf Scholz and are expected to help tilt the European parliament towards a more anti-immigration and anti-green stance.



In Italy, Prime Minister Giorgia Meloni’s hard-right Brothers of Italy clinched 28.6% of the vote, improving on its tally of 26% in the 2022 general elections. The strong performance cemented Meloni’s position as the dominant figure in her governing coalition and will strengthen her hand in negotiations with other European leaders.

Mexico

Mexican voters elected Claudia Sheinbaum of the ruling Morena party as president for the next six years. Ms. Sheinbaum is regarded as the protégé of Lopez Obrador, the outgoing president. Mr. Obrador is leaving the healthcare and education systems in tatters, while Mexico appears more dominated than ever by drug cartels. Critics accuse Obrador of overseeing a high homicide rate and increasing numbers of missing people. Security remains Mexico’s top concern.

For more than a decade, the dominant drug groups have been fragmenting, generating a host of smaller splinter gangs who fight over turf. Today, the two largest and most powerful cartels are reportedly jostling with smaller rivals. The cartels have reportedly expanded into lucrative new businesses. In a new report, the U.S. Drug Enforcement Administration described the two leading Mexican cartels as “transnational criminal organizations” because they are involved in arms trafficking, money laundering, migrant smuggling, bribery, extortion, and a host of other crimes. The cartels control more territory than ever before (about one-third of the country) according to one estimate by the U.S. military. Mexico is becoming a failed state as the cartels economic power has grown, and so has their international reach.

While official statistics on crimes such as murder are questioned by independent researchers, experts agree that the power of organized crime now represents a serious risk not only to the population but to businesses and the economy. It is one of the reasons why the country appears to be failing to fully capitalize on its potential to draw manufacturing away from China. A Mexican business leader, speaking off record because of the sensitivity of the subject, opined that security has deteriorated dramatically under Lopez Obrador and that the government has played down the problem. Obrador has painted a picture of his administration doing all it can to tackle the problem of crime, while blaming his predecessors for creating it. According to the records, the expiring six-year term of Lopez Obrador was Mexico’s most violent, with more than 175,000 killed and 43,000 missing. Notwithstanding that, Obrador’s approval rating remained at 65% and barely changed over the past three years.

Criminal groups are also interfering more brazenly in elections. The campaign that just ended included races for federal and state congresses, governorships, and mayoralties. It was the deadliest ever. 36 candidates and another 45 people linked to the elections were murdered, 15 more were kidnapped and dozens of others threatened.



The new president has a chance to redefine Mexico’s relationship with the U.S. Security is related to migration because criminal groups facilitate much of the northward movement of people through Mexico to the U.S.

Also, Mexico’s gangs are the primary manufacturers of fentanyl which along with other synthetic opioids, kills some 75,000 people north of the border every year. The U.S. and other countries want desperately for Mexico to do better at curbing gangs’ production and distribution of these substances.

Publicly the President elect Ms. Sheinbaum hews closely to the ideas of Lopez Obrador, her mentor. But many are hoping that she will be far more pragmatic.

India

Voters handed Prime Minister Modi an unexpected re-

buke in India’s just completed general elections. While the ruling Bharatiya Janata Party (“BJP”) was returned to power, it did so with a much-diminished majority in parliament. The BJP and allied parties won 292 seats in India’s 543-seat parliament. The BJP’s tally fell short of the outright majorities the party won in the 2019 and 2014 elections.

The predictions were that Mr. Modi, and the BJP would have won in a landslide given his charisma, combined with an emphasis on infrastructure development, welfare payments to the poorest and a polarizing Hindu nationalism. The Prime Minister exuded a confidence that matched those predictions, claiming that his BJP and its allies would win upwards of 400 of the 543 seats in India’s parliament. Instead, the BJP lost 63 seats compared with the last elections in 2019, ending with a tally of 240, down from 303 in 2019. Crucially, this means that the government will rely on its alliance partners to control parliament (272 seats are needed for a majority).

The electoral surprise shocked the public, the political world, and financial markets: the country’s benchmark share index fell by 6%. Opposition politicians and other critics had complained during the campaign of the lack of a level playing field in the election. Opposition politicians were jailed on corruption charges that they called politically motivated. The Congress party, the main opposition, had its bank accounts frozen, hindering campaigning. In addition, Mr. Modi at times resorted to stridently anti-Moslem rhetoric, which sparked fear among India’s largest minority Moslem communities.

There appears to be a sense that the economy is not delivering for ordinary people. Despite strong growth figures, voters cited inflation and unemployment as concerns. Big upsets against the BJP in the states of Upper Pradesh and Rajasthan likely reflect concerns among members of lower castes that the BJP could roll back affirmative-action policies. The opposition tapped into such fears, emphasizing Mr. Modi’s closeness to oligarchs, and claiming that the BJP might remove constitutional protections

for lower-caste groups and religious minorities.

Prime Minister Modi's once all-powerful personal appeal has dimmed. He will certainly be able to put together a government and remain as PM, as the BJP still has the largest representation in parliament. However, he will be forced to become more circumspect and to seek broader consensus in his new term. The election bodes well both economically and politically for India. Before the election, policy was determined by the prime minister's office and the bureaucracy, then rubber-stamped by parliament.

Agricultural reforms, passed without parliamentary consensus, were eventually withdrawn in the face of farmer protests. Modi's coalition partners and the much stronger opposition in parliament will, hopefully, prevent unilateral policy measures. But reforms to land and labor laws, which need more consensus building, may be back on the table. A chastened Modi government may also aim to make growth more job-intensive, improving a number of households. If the government focuses on equipping youth with employable skills and reviving small and medium size enterprises in labor-intensive sectors, economic growth could become more inclusive even in the short run.

In April, foreign investors dumped \$1 billion worth of Indian shares. In May they dumped another \$4.2 billion. This is a sliver of the roughly \$900 billion of Indian shares in foreign hands, but it is striking. The share of the Indian stock-market held by foreigners is now at 18%, its lowest in twelve years.

The explanation for this trend is that the election had prompted jitters amongst investors. Indian companies are expensive, trading at double the level of their book value and their Chinese competitors. Still, the Indian economy has performed well in recent years and its firms offer superior returns on equity and they are deleveraging, meaning they are producing more profits while taking less risk.

A more convincing explanation rests on how India treats foreign investment. The country has never been a straightforward destination for international capital, owing to disclosure rules and taxes on capital gains and dividends. Until recently, such taxes could be avoided or minimized if the investing company was registered in a country with which India has a tax treaty. The most popular such countries were Mauritius, which since 1983 has offered an escape route from Indian levies, and Singapore, which has a treaty designed to mirror Mauritius'. Changes have been made to this practice. In March, Indian officials confirmed reports that tweaks to its treaties might put older funds at risk.

Local investors were annoyed that foreigners received better tax treatment; some channeled domestic investments via foreign funds to minimize tax bills. That, in turn irked officials, since local investors were able to avoid India's stringent disclosure requirements.



One of PM Modi's signature projects: the Gujarat International Financial Tec-City (GIFT City) is home to 660 companies. A new regulator, The International Financial Services Centers Authority, is intended to consolidate the usual Indian regulatory chaos into a single Singapore-style mechanism for efficient control. Among a rush of new laws drafted to support GIFT City are ones allowing investment funds to move from Mauritius with-

out triggering the kind of liquidation and taxable event that such a move would normally entail. Dozens of little rule changes have been made to welcome reinsurance and aircraft -finance firms that would run into ownership restrictions and other impediments elsewhere. Over a hundred local Indian funds have registered in the city, drawn by provisions expanding the limited rights Indians have invest overseas. Banks have been pushed to add workers.

The rules applicable to equity investment remain half-formed and muddled. Among the rule changes are ones to allow securities listed in Mumbai's stock exchange to trade on stock-exchange affiliates in GIFT City in dollars, which may offer a boost. Bureaucrats with ties to Mr. Modi have been installed. Ironing out the problems will be a post-election priority. Until things improve, foreign investors will likely see the messy situation and conclude that, for now, it is best to stay away.

Indian analysts argue that the government also needs to review its plans for manufacturing exports-led growth, based on protectionist tariffs and subsidies. Currently, India accounts for 5% of global services exports (and less than 2% of goods exports). Exports of high-skilled services, such as consulting, telemedicine and design and software embedded in manufacturing could lead the way. That will require a shift in spending, for example repurposing billions of dollars of subsidies from capital-intensive chip manufacturing to investments in quality childcare, schools, and colleges. Service exports would also benefit from stronger data privacy laws, including protection from government intrusion - something a democratic India could enact.

A more democratic India will be a more reliable friend to democracies around the world. India can be a bridge-builder in a fracturing world. The recent election shows authoritarianism can be halted.

Turkey

President Erdogan's government has struggled to tame runaway inflation after introducing a sweeping economic overhaul. The inflation crisis rages a year after the government moved to turn the economy around. Consumer expectations of further high prices pose challenges for Turkey's central bank in reining in price growth.

Consumers complain of not being able to afford to pay high prices for meat and fresh fruits. While inflation seemed to have peaked at 85% in 2022 it is still trending at 67% - among the highest in the world.



The central bank has increased its main interest rate to 50% from 8.5% since the economic overhaul kicked off in June 2023. The maximum monthly interest rate on credit cards, a popular way of borrowing for cash-strapped consumers, has tripled since last June. The government also boosted taxes and signaled that it would not lift the minimum wage again this year, following a 49% rise in January. It plans to cut public spending on everything from foreign cars for the government fleet to construction of new government buildings.

President Erdogan's program has drawn accolades from investors. However, the program has yet to pay dividends for Turks, who face inflation of nearly 70%, surging borrowing costs and a reduction in the stimulus measures

that in recent years dulled the impact of price growth. It is a bitter medicine. Pensioners and those on low income are hurting the most in the fight against inflation.

The central bank's goal is to quell the long-running inflation crisis triggered by Erdogan's former policies, which centered on a failed wager that low interest rates would cure rather than cause high inflation. Mr. Erdogan pledged in May that there would be no turning back from the new plan, signaling the government would not provide "temporary relief" as it had in the past, including the huge handouts before his re-election in May 2023.

Turkey's new program is slowly rebuilding confidence among international fund managers, who have poured almost \$10 billion into Turkish equities and lira-denominated government debt over the past year. S&P Global Ratings and Fitch have upgraded Turkey's rating this year, while high rates are cooling lending growth. However, the situation at grocery stores and shopping malls has yet to reflect this improving picture. The working poor reportedly cannot afford basic needs of nutrition, shelter, and transportation. Many consumers remain doubtful the new economic measures will be successful, having watched the central bank miss its inflation target every year since 2011.

Voters rebelled against the long-running inflation crisis in local elections held in March, which dealt Erdogan's ruling Justice and Development party its biggest defeat since its founding two decades ago. Inflation expectations are persistent because of the credibility erosion over the past years. Financial markets seem to partly buy the disinflation story; but it is more challenging when it comes to expectations of households and small businesses.

The central bank is projecting annual inflation to fall to 38% by year-end 2024 after hitting 75% in May. However, a recent study revealed that consumers anticipate the inflation rate will hit 80% in a year's time. More than 90% of consumers in a separate survey conducted by

Koc University, said now is a good time to buy long-lasting goods, a sign they believe prices will continue rising. These expectations are a key challenge for the central bank in bringing down price growth, as they cause demand to be pulled forward, contributing to the spiral of ever-higher prices. The consensus among local economists is that the current level of tightening is not enough, both in terms of monetary and fiscal policy.

The central bank forecasts suggest that the year-end economic growth rate will be approximately 2.1%, much faster than estimates released earlier this year. However, the consensus is that economic growth has to slow much more to bring inflation to the desired path. The main question is whether the authorities will be patient enough to withstand the political consequences of this bitter stabilization process. As part of the shift to a more orthodox economic policy, the government has started to increase taxes as well as interest rates, and is limiting access to credit, which will affect consumer spending and government expenditure. High inflation will also limit private consumption growth after credit-fueled consumption in 2023. Fixed investments will likely continue to grow (although at a more modest pace), reflecting greater confidence in the direction of economic policy.

Brazil

Latin America's largest economy remains burdened by high public debt/GDP ratio and tepid growth. Structural reforms are needed to lift competitiveness and productivity. A new fiscal framework is likely to anchor debt sustainability over the medium term.

President Lula and his Workers Party (PT) will struggle to advance parts of his progressive agenda through Congress for the remainder of his term. Lula is likely to run for re-election in October 2026, but modest economic growth creates the chance for a right-of-center candidate to emerge victorious.

The government has relaxed its fiscal targets for 2025 and beyond, raising concerns about its commitment to



curb spending. Insufficient fiscal consolidation and weak GDP growth underpin the forecast that public debt will climb to 90% of GDP by 2028. A proposed progressive income tax reform could help ease fiscal pressures, but it will be tricky to pass. Allies of former president Bolsonaro dominate Congress and may not be willing to compromise with President Lula.

GDP growth is expected to decelerate in 2024 to 2%, but interest- rate cuts will support consumption and investment. A recovery in global growth in 2025 will buoy Brazil’s economic outlook. Slow progress on growth-enhancing, structural reforms and low labor productivity is forecast to keep average annual GDP growth moderate in 2025-28. Following flooding in the southern state of Rio Grande do Sul, government relief and reconstruction spending are unlikely to fully offset the hit to agriculture and industrial production. Given flood-related crop damage, the forecast for the 2024 overall fiscal deficit has been adjusted to 7.7% of GDP. For the same reason, inflation is expected to end 2024 at 3.9%.

Aid for Rio Grade do Sul: Further details of state and federal government relief and reconstruction efforts are likely to emerge shortly, providing a clearer picture of the extent to which the stimulus will offset the flood-related hit to production and services. More details of the damage to agriculture, industry and services will take several

weeks to materialize.

Monetary easing by the central bank (Banco do Brazil), will erode interest-rate differentials with the U.S. until rate cuts begin in the U.S. Meanwhile, low public external debt payments and a large trade surplus will contain Brazil’s external vulnerabilities. The central bank is expected to make two additional 25-basis-point cuts this year, bringing the Selic rate to 10% by year-end.

The government sacked the head of Petrobras (the state-controlled oil company). His replacement is likely to tolerate more investment in downstream activities, in line with President Lula’s aims for the company, even though this strategy could hurt shareholder value. President Lula’s non-aligned foreign policies and push for a multipolar world will make Western powers uneasy. Trade and investment will not suffer too badly, but the ratification of a free-trade deal between the EU and the Mercosur regional trade block now appears less likely.

*Written by Byron M. Shoulton
Senior Global Economist
FCIA Trade Credit & Political Risk Division
Great American Insurance Group
For questions / comments, please contact Byron at
bshoulton@fcia.com*

FCIA is a division of Great American Insurance Company that offers an array of flexible, short or medium term coverages against non-payment risks on accounts receivable.

To sign up for FCIA Major Country Risk Development and more information on FCIA insurance coverages, please visit us at www.FCIA.com.

FCIA Trade Credit Insurance solutions can help with:

- *Sales expansion*
- *Reduce earnings volatility related to bad debts*
- *Alleviate buyer risk concentration issues*
- *Mitigate emerging market political risks*
- *Improve access to financing from banks/ FIs*

