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Trade Credit & Political Risk

GREAT AMERICAN INSURANCE GROUP

Major Country Risk Developments
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By Byron Shoulton

Overview

Fears that Israel's expanding military operations in the Gaza strip - in response to Hamas attacks and kidnappings of Israelis - could escalate into a regional conflict are clouding the global economic outlook. Some sentiment has shifted amid fears that wars in Europe and the Middle East threaten to dampen growth and reignite a rise in energy and food prices. On the bright side, a rebound in manufacturing as well as in services (travel, recreation, tourism) has kept employment tight; and advancing technology applications are expected to boost productivity. Some growth projections for next year cite these trends as likely to contribute to stronger global growth of 2.6% versus 2.2%.

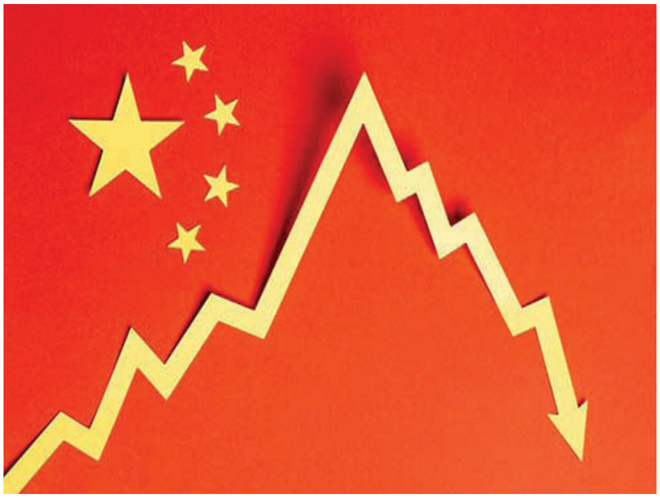
Rich and poor nations were just beginning to catch their breath after a three-year string of economic shocks that included the Covid-19 pandemic and Russia's invasion of Ukraine. Stinging inflation has dropped, oil prices stabilized, and predicted recessions were avoided.

Leading international financial institutions and private investors warn that the fragile recovery could unravel. Nations are already struggling with unusually high levels of debt, limp private investments, and the slowest recovery in trade in five decades, making it tougher for them to grow their way out of the crisis. Higher interest rates, the result of central banks' efforts to tame inflation, are making it more difficult for governments and private companies to get access to credit and stave off default.

Moody's cut its credit outlook for China's credit rating from stable to negative, warning that the financial stresses of some regional and local governments will require the central government in Beijing to provide support to them. That could weigh on China's government finances at a time when its economy is slowing.

Chinese cities and provinces have as much as $11 trillion in off-balance-sheet debt, according to some estimates. A large trunk of this debt is believed to be at a high risk of default and could cause significant losses for banks and investors that have lent money to local governments.

In addition, a sharp rise in Chinese consumers defaulting is the latest in a lengthening list of ailments afflicting the Chinese economy. The number of people blacklisted for missing payments on mortgages and business loans has risen to a record 8.54 million, up from 5.7 million in 2020.



The rate of increases in defaults even since China rolled back its pandemic lockdowns a year ago, and rising financial distress at the individual level, is contributing to stiff headwinds that are frustrating a broad recovery in consumer activity. Without energizing consumer spending, China may struggle to drive sustainable economic growth-which the IMF is forecasting will slow to 4.6% in 2024 (from 5.4% in 2023).

In Venezuela, a referendum on a disputed area in neighboring Guyana ended in a win for the proposition by the Maduro government to make disputed Essequibo a state of Venezuela. The result of the referendum is particularly alarming as Essequibo constitutes almost 20% of Guyana's land mass and is known to have large deposits of oil and gas. Guyana is, today, among the fastest growing economies due to offshore drilling that is yielding vast amounts of crude and potential gas reserves.

The Guyanese government is obviously alarmed at this apparent attempt at a land grab by Venezuela and is seeking U.S. and United Nations support as it invokes sovereignty claims over the disputed territory. Venezuela's claim to Essequibo is longstanding but was deemed settled after Guyana sought and gained independence from the British in the 1960's.

USA

Inflation has cooled markedly in 2023 and could bring the Federal Reserve's (Fed) interest rate increases to an end in 2024. Core prices rose 2.5%, down from 4.5% over the previous six months, a dramatic improvement. Officials at the Fed are likely to hold interest rates steady at a 22-year high at its December FOMC meeting. The big question remains when will the Fed end the current rising cycle. With borrowing costs double their levels from just two years ago, many U.S. small businesses are reportedly pulling back, another sign of how higher interest rates are cooling the U.S. economy.

Some entrepreneurs are postponing equipment purchases and expansion plans, while others are delaying new hiring, rethinking loan terms, or stepping up efforts to collect payments on time. Keeping borrowing costs in check and managing cash flow is an added challenge for business owners already dealing with labor shortages, inflation and economic uncertainty.

The average interest rate small businesses paid on short-term loans has stood at 9% or higher over the past three months, according to the National Federation of Independent Business, up from 6.7% a year earlier and 4.6% in August 2021. The Federal Reserve voted unanimously in November to leave interest rates unchanged at a 22-year high and a broad slowdown in inflation in October suggests no additional increases are likely in this cycle.

The impact of higher rates is already being felt in other parts of the economy. Home sales have fallen as rising rates keep buyers on the sidelines and sellers from listing their homes. Hiring has slowed. Business investment appears on hold. Small business owners worry about being able to make loan payments in January and February when sales normally slow. Many have delayed plans for purchasing new equipment until spring 2024 while they hope to accumulate enough cash to cover the expense.

This trend is slowing overall growth prospects. When the cost of capital was lower, it was easier to take on a bigger risk and bite off a little more. Financing pressures are coinciding with the end of government aid programs that helped entrepreneurs through the Covid-19 pandemic, contributing to the biggest jump in small-business bankruptcy filings since the start of the pandemic. More than half of small-business owners reported that higher interest rates were affecting their business, according to a recent survey of 450 small-business owners conducted in October, while 19% anticipate they will be impacted.

Over 20% of entrepreneurs reported that higher rates and tighter lending standards were influencing hiring decisions, according to the survey. Small businesses tend to operate with thinner profit margins and smaller cash reserves than larger companies and have fewer financing options. That makes them particularly vulnerable to the Federal Reserve's efforts to slow inflation by raising interest rates.

Small businesses spent roughly 6% of revenue on interest payments in 2021, before the recent round of rate increases, versus 2% for larger companies. The difference reflects higher rates on small-business debt and higher debt-to-output. The dollar value of new small-business loans declined 16.8% in Q2-2023 compared with the same period a year earlier, reflecting rising rates, weaker loan demand and tighter lending standards.

Fifty-three percent of small businesses say they cannot afford to take out a loan at current interest rates, according to an October survey of more than 1,200 small businesses. The 9.8% average interest rate that small businesses paid in September was the highest since December 2006. Suppliers in the construction and petrochemical industries confirm a need to add new production lines but admit they cannot bring in enough inventory because of inadequate warehousing space. Some businesses with approved financing for expansion are unwilling to move forward because of high borrowing costs. Many entrepreneurs are looking to better manage interest expenses and cash flow as financing costs climb.

A top official at the Federal Reserve has sent the strongest signal to date that further monetary tightening may not be needed given clear signs that the economy is slowing to a degree necessary to bring inflation fully under control. With consumer spending slowing alongside business activity and labor demand, overall growth is expected to be a modest 2.2% in 2024.

Eurozone

Inflation in the eurozone has fallen far more than expected to 2.4% in November. This is the slowest annual pace of inflation since July 2021, providing some relief to consumers and fueling hopes that cuts to interest rates could soon begin. The sharp fall from 2.9% a month earlier adds to tensions between investors who hope rates will be cut soon and central bankers seeking to keep borrowing costs high until the biggest surge in inflation for a generation has been definitely tamed.

For the eurozone, falling energy prices and lower growth in food and services prices were the main factors behind the slowdown of consumer prices, according to data from Eurostat.

Furthermore, the slowdown in Eurozone bank lending stabilized in October through November after a pick-up in monthly credit flows for mortgages, according to data from the European central bank ("ECB"). Net mortgage lending rose by 12 billion euros in November, the biggest monthly increase in more than a year, largely driven by a jump in French home loans. This follows several months of declining or weak growth in mortgages after rising interest rates triggered a decline in home purchases and falling property prices.

The ECB is monitoring the impact of its rate rises on bank lending, a key indicator of wider economic activity. The consensus is that lending is unlikely to rebound vigorously. Instead, it appears lending could slow further over the coming months, as interest rates faced by firms and households have continued to rise, and credit standards remain tight. Bank lending has reportedly dried up since the ECB raised its benchmark deposit rate to 4%, the highest level in its history, from an all-time low of minus 0.5% last summer, in an effort to tame the biggest surge in inflation for a generation. The squeeze - also driven by the expiry of the ECB's cheap loans to banks- has hit the supply of credit to non-financial companies, which fell 0.3% in the year to October. That is the first annual decline in corporate lending since 2015, when Europe was still emerging from a major debt crisis.

Falling corporate lending will weigh on investment and sap growth in a eurozone economy that has already ground to a halt, with GDP shrinking 0.1% in the third quarter. Europe relies more heavily on bank lending than the U.S. and many other countries, making growth and inflation in the 20-country single currency bloc particularly sensitive to changes in credit supply.

The ECB reports that annual growth in lending to eurozone residents remained in negative territory, contracting by 0.5% in October. However, credit in the private sector grew 0.4% from a year ago, up from 0.2% the previous month. Governments are reducing the amount they borrow as they look to reduce budget deficits. Restrictive monetary policy is playing a role in reducing loan growth and is putting negative pressure also on deposit balances. These trends are expected to continue over the short term and start recovering later when short-term rates find stability and the economic environment improves.

Bank deposits continued to shrink, falling 2.2% from a year ago. This reflected an 11.5% drop in low-yielding overnight deposits, which are partly offset by rapid growth in term deposits that offer higher rates but can only be withdrawn after a period of time.

Companies' access to credit is declining faster than their demand for borrowing according to a separate November survey of more than 11,500 businesses published by the ECB. It found that the net share of businesses reporting greater need for bank loans rose to 5% in the period from April 2023 to September; up from 4% in the previous six-months. Also, the share of companies reporting lower availability of loans rose to 10%. The financing gap continued to widen at a moderate pace.

The share of companies reporting "major difficulties in running their business and servicing their debts over the past six-months" rose to 9%, up from 6% in the previous survey. That takes the level of financial vulnerability close to where it was during the Covid-19 pandemic, when it was reported by 10% of companies.

Germany is to suspend its constitutional limit on new borrowing for the fourth consecutive year, as it rushes to deal with the fallout from a ruling by the country's top court that has left its spending plans in disarray. The Finance Ministry will present parliament with a supplementary budget for 2023 "that will put spending made last year on a firm constitutional footing." November has been a difficult month for German industry as several large climate-related projects, such as long-awaited rail infrastructure investments, have been thrown into doubt after the government froze payments from a climate and transformation fund. The freeze followed a decision by Germany's top court that 60 billion euros allocated to the fund, designed to help decarbonize industry, was illegal.

Meanwhile, the chief executive of steelmaker Salzgitter has warned that Germany's big energy users must commit to the country as a base – to stave off creeping deindustrialization of Europe's largest economy. The head of Germany's second-largest steelmaker warned that if manufacturers of materials needed for industry, such as steel or chemicals, were to leave the region due to high energy costs, they run the risk of losing the whole value train of production.

The comments come as 32% of industrial companies told the German Chamber of Commerce and Industry that they favored investment abroad over domestic expansion - double the 16% identified in the previous year's survey. This comes amid concern over a future without cheap Russian gas supplies.
Salzgitter has confirmed that one billion euros promised by local authorities to help the company build plans that run on both gas and cleaner hydrogen were secured, despite problems surrounding the climate fund. The company is planning to have the first phase of these plants running by 2026.

The German steel industry is making a big bet on future demand in Europe for so-called green steel, as it pours billions of euros into a transition that will eventually see it replace gas furnaces with technologies reliant on clean hydrogen and electricity.

Salzgitter, which employs 5,500 people, has been bullish on the future of carbon-reduced steel and promised not to use any more coal in its production by 2033, when it expects to have cut its carbon footprint by 95%. There remains however, a question mark over how demand for green steel would be affected if large-scale industrial environment-friendly projects were to be scrapped. The funding gap puts a lot of pressure and responsibility on the German government to come up with a tentative solution, in a relatively short timeframe.

Argentina

Javier Milei's election, as president of Argentina, puts the country on an unknown path, while rejecting the failed Peronist policies of the last three decades. Milei, a 53-year-old libertarian economist and political outsider, pledged to lay waste to a political establishment he considers corrupt. A majority of Argentines concur.

Mr. Milei proposes dollarizing the Argentine economy, but the country's treasury has no dollars with which to do so. Mr. Milei also seek to take Argentina out of the Mercosur trade block which allows Argentina duty free access in trade with member countries [Brazil, Uruguay, Paraguay, Argentina]. The likely advantages to Argentina should it withdraw from Mercosur remains unclear. Milei wants to abolish the central bank but is unclear about what will replace it. He has vowed to cut the size of the state by half by selling off inefficient and mismanaged state-owned assets to the private sector.

The President-elect won the election with 56% of the vote. He defeated Sergio Massa, the incumbent economy minister and the architect of policies that produced 143% inflation, declining living standards, the worst economic crisis in decades, and zero foreign exchange reserves. Mr. Milei has been given an opportunity to restructure Argentina's economy at a time when such changes are desperately needed. However, he lacks support in the Argentine Congress. Furthermore, many of Mr. Milei's ideas are short on details. His movement is new to the political scene and will have to form a coalition with conservative and centrist politicians to enact any meaningful legislation. That will be difficult.

The outgoing Peronists control the largest faction in the Congress, and they will oppose Milei every step along the way. It is left to be seen how independents and moderates will respond to Milei's agenda.

The Argentine peso lost 90% of its value against the dollar, and the middle class is increasingly impoverished. This is the result of industrial policy, export taxes, capital controls, rigid labor markets, uncontrolled government spending and the political abuse of the central bank to monetize the spending.

This policy mix failed repeatedly, yet Argentines kept returning Peronists to power. Mr. Massa tried buying the election with handouts to voters, a practice known as the Peronists way. This time, the hardships felt by voters were such that a solid majority shifted support to an unknown and untested outsider. Meanwhile, Argentina lost access to global capital markets some years ago.

At a minimum, a country should have comfortable FX reserves and/or access to global capital markets to switch to a foreign currency as its own legal tender. According to some estimates, Argentina would need to borrow around $30 billion to dollarize its economy. Dollarization works best for countries that are well integrated into the global economy. Argentina is viewed as being among the world's most closed economies. In addition, Argentina's commodity-based export platform has a different business cycle than in the U.S. This means that monetary policy decisions in the U.S. could have an adverse effect on Argentina's economy. Without its own currency, Argentina would lack monetary tools to cushion external shocks. The Argentine courts are another challenge to dollarization. One Supreme Court magistrate has already opined that replacing the Argentine peso with a foreign currency would be unconstitutional and violate national sovereignty.

The stakes are high for Argentina's 46 million people, who have suffered misrule and corruption over many decades. Mr. Milei is known for his caustic language and rhetoric, with which he electrified desperate younger Argentines on the campaign trail. Now he must convert that energy into meaningful reforms that set the country on a new path which embraces economic liberty and political freedoms.

If Mr. Milei fails to bring about reform due to incompetence, he will discredit market policies in Argentina, which could put the Peronists back in power. The President-elect has made promises of better days ahead. The world hopes he has the skills needed to deliver on those promises.

South Africa

South Africa's Treasury has warned that the country's stagnant economy has left the government with far less tax revenue than planned. A recent medium-term budget update cited rising fiscal pressures on Africa's largest economy that would strain scarce public resources and result in action to review and reconfigure the structure and size of the state.

Rolling power blackouts and logistics crises at the troubled Eskom and Transnet state monopolies have hit South Africa's economic growth this year, along with profits of major taxpayers, including mining companies. The Treasury confirmed that the state would collect some $3 billion less in taxes than was projected this fiscal year. As a result, the 2023 budget deficit will be approximately 5% of GDP versus the 4% initially planned. The gap is widening as South Africa faces higher borrowing costs resulting from the global increase in interest rates.

Transnet's inefficient running of South Africa's commodity freight railways reportedly cost the economy the equivalent of 6% of the country's GDP in 2022. The company has warned that it will not be able to sustain its $30 billion debt load without additional state help. However, the government insists this can only happen if the company commits to deep reforms. President Ramaphosa's government is already providing a costly bailout to cover Eskom's debts over the next few years, to give the electric utility financial space to turn around its decline. The path to stabilize South Africa's public finances remains narrow.

The challenge is that rising debt service costs are crowding out important social spending, while the economy has not grown fast enough to support increasing expenditure or the country's current debt levels. South Africa's average borrowing costs across its debt has risen 9.5%, versus 8.3% earlier in 2023. Foreign holdings of South African bonds have fallen markedly in recent years and local investors have been cautious about absorbing more debt issuance.

In Africa's most industrialized economy, the energy sector is about 70% dependent on coal. Per capita carbon emissions stand at about 6.7 metric tons a year, comparable with countries in Europe and higher than the UK's 4.6 metric tons.

Two years ago, at the United Nations COP26 meeting in Glascow, the U.S., EU, UK, France and Germany pledged to provide finance worth $8.5 billion to help South Africa shut its coal plants down more quickly than scheduled while supporting an equitable, inclusive transition through a entity called Just Energy Transition Partnership. The crucial word here is "just"- meaning that greener energy would not come at the expense of jobs and communities. South Africa remains deeply divided along racial lines 30 years after apartheid. Coal is one of the few industries in the nation that has undergone a transition into black ownership. About 100,000 people work directly for the coal industry in a country

where at least one in three people are unemployed.

Shutting down state-owned coal-fired power plants and accelerating the transition to solar and wind-built by private companies – is highly controversial. So is the idea of decommissioning coal-fired stations more quickly in a country where regular power cuts of six hours a day are crippling industry and antagonizing voters. The state-owned electric utility Eskom complains that money promised for energy transitioning did not materialize, and that much of the funding consists of loans and guarantees not grants. The South African treasury is "broke" and doesn't want to load up on more debt to please Western environmentalists, Eskom says.

In October 2022 the World Bank provided $497 million to repurpose Eskom's Komati power station from coal use to alternative power sources. The company's complaint is that the plant was shut down too quickly before proper plans had been put in place, for example by training workers to make small off-grid solar power units. In other words, the plan to go green is one thing but executing the plan is quite another.

Last month, the ruling African National Congress (ANC) kicked-off the campaign for South Africa's most consequential election since the end of apartheid – to be held in 2024. Despite ongoing attempts to drum up enthusiasm for the ANC - which has governed South Africa since the advent of democracy in 1994 – the party is now facing the real prospect of losing its grip on power.

Swaths of South Africans are dissatisfied with the ANC even while President Ramaphosa personal polling is better than the ANC as a whole. Support for the ANC, which won 57% of the vote in the last election in 2019, has fallen below 50% in recent polls. This raises the prospect that the ANC will likely have to haggle with other parties to form a coalition government.

High unemployment (40%+), weak investment, power blackouts, a feeling of economic exclusion and despair persists among growing numbers of South Africans, putting the incumbent ANC on the defensive. Younger voters (many of whom lack access to jobs and opportunities) are disillusioned or distanced from the ANC; others may not vote. Even among the ANC's strongest voter base, the party's failings are visible. At all levels, citizens and businesses ask when and how will the South African economy be revived.

South Africans are deeply uncertain about what the future holds. Some believe the country is in a messy and unpredictable transition. The country is now in its longest downward phase of the business cycle since 1945. It is no exaggeration to say business confidence has been depressed for a decade. The once promising developmental state has become enfeebled. This is creating heightened risks - but also opportunities for an innovative private sector and vibrant civil society seeking an alternative to big government. The most hopeful outlook is that the country can capitalize on its emerging strengths and deepen existing reforms to raise growth rates above 2% per annum over the medium term.

The Steel & Engineering Industries Federation of Southern Africa blames a lethal cocktail of a lack of infrastructure spend, weak demand, rapid import penetration, crippling input costs increases and unreliable municipal services, among other issues. With margins already thin and many firms in survival mode, the country's electricity crisis threatens to tip the sector over the edge.

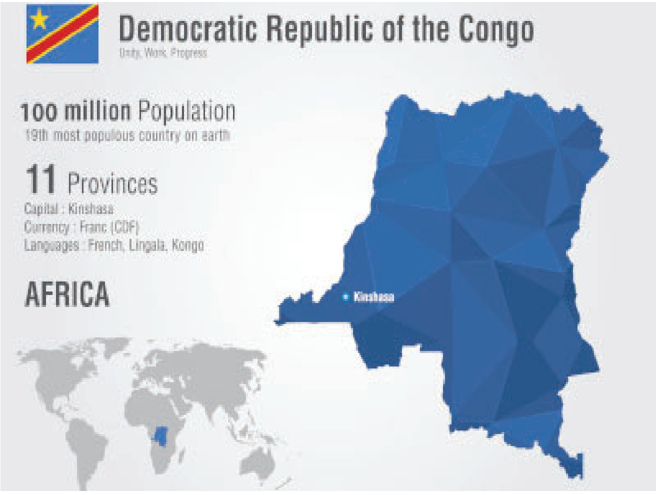
The Minerals Council South Africa says the sector has been hamstrung by unclear or continuously changing mining charter requirements for prospecting rights. The existing system has been disastrous and has severe backlogs in the processing of applications for exploration and mining rights.

South Africa's continued economic underperformance reflects a failure to get on top of longstanding structural constraints that have raised the cost of doing business and made it a far less attractive investment destination.

The Treasury has already launched measures to contain spending outside education, health, welfare grants and housing. It flagged $2 billion of tax rises coming in next year's budget. That budget will fall amid the battle by the ANC to retain its national majority, with recent polls indicating ANC support continuing to slip. Unfortunately, a viable alternative to the ANC appears far from prepared for assuming the leadership of Africa's most industrialized economy.

Democratic Republic of Congo

Voters in the Democratic Republic of Congo (DRC) will go to the polls to elect a new president on December 20, 2023. Opponents of the sitting government have cast doubt on the voting process, warning of the likelihood of corruption and a lack of transparency in the polling results.



The DRC is home to more than one hundred million people. The country is blessed with enormous mineral wealth such as cobalt, a critical component in battery technology used to power electric vehicles. Yet, the DRC remains one of the world's most underdeveloped countries, and one racked by poverty and violence. There are some twenty candidates running for president.

The current president, Felix Tshisekedi, is son to Etienne Tshisekedi who became a leading opposition figure after serving as prime minister under the kleptocratic ruler Mobutu Sese Seko when the country was known as Zaire. Mr. Tshisekedi's election 5 years ago, was called into question by both the opposition and the Catholic Church, but he has always denied election fraud and is seeking a second term. He leads a multi-party Sacred Union coalition comprised of more than two hundred parties and vows a clear and convincing victory this time around. Both the opposition and the church remain skeptical toward this month's contest, stressing that there is "no certainty that the upcoming elections will be free, inclusive, transparent and peaceful."

The U.S. government has called for a fair election and indicated that it would consider imposing visa restrictions against those undermining democracy in the DRC in the event of election-rigging, corruption, or voter intimidation. There remains very little confidence in the electoral process.

However, the consensus is that Tshisekedi has a chance of legitimately winning a majority of the votes given his visibility after five years in power and the backing of the state machinery. This is especially possible amidst confusion among a divided opposition that is split between three main characters. Tshisekedi's campaign strategy seems to focus on promoting security in Eastern DRC

One key political figure has yet to make his intentions known: Joseph Kabila. He was president for 18 years until Tshisekedi took over in 2019. That interrupted more than two decades of Kabila family rule. Joseph Kabila remains a strong presence within Congo's political, economic, and military institutions he Has strong networks developed during his years in power. He could use this influence to sway the vote towards any of the candidates. Kabila's influence stems from favorable business and political alliances he created while in office.

Whether the elections take place is another area of concern. There are concerns that the sitting president will delay or cancel the election by citing security concerns. If this happens, it might be perceived by domestic and international partners as political manipulation by the ruling regime.

The DRC is auctioning rights to explore for oil in large areas of rainforest and other protected areas. The country's hydrocarbons minister explained that the country needs to extract oil and gas so that the populace can eat and the government can develop the economy. Some of the oil blocks lie within the Congo basin rainforest, which is populated by small farming and fishing communities. The lack of infrastructure raises questions over how realistic oil exploration is.

The government has so far struggled to attract bidders for the oil blocks, and some oil majors such as TotalEnergies have decided not to take part. Finding funding and insurance for projects to extract oil

in the rainforest may also prove difficult.

China is the DRC's largest trading partner. Chinese mining company CMOC Group says it expects electricity supply issues in the DRC to remain a constraint on expansion of its cobalt and copper production in the country. The DRC is the world's top cobalt supplier and the third largest copper producer after Peru and Chile. The country has struggled with power shortages, as well as difficulties getting metals to ports in South Africa, Tanzania, and Namibia for export. A recent wildcat strike by truckers had stranded copper and cobalt from mines including CMOC's Tenke Fungurume.

Electricity supply is sufficient for CMOC's existing capacity, but power is the main impediment for future growth of its DRC operations. To improve the power supply, CMOC has been looking to tap hydropower projects and other new energy sources.

Written By Byron Shoulton
FCIA Senior Global Economist
For questions / comments, please contact Byron at bshoulton@fcia.com

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