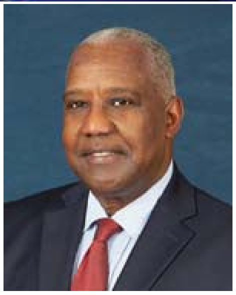
Major Country Developments

April 2019



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Overview

U.S. economic growth in the first quarter is starting to look stronger, a welcome turnaround after recent concerns that the recovery may have peaked. GDP growth forecast of 2.2% for 2019 remains the consensus. While earlier speculation suggested that the U.S. housing and construction sectors were beginning to slow, recent data indicate activity has gained some momentum. Likely contributing factors are lower mortgage rates and a shift in Federal Reserve strategy to hold off further interest rate hikes. Furthermore, the continued strong U.S. jobs market is undergirding consumer confidence and providing prospective home buyers with incentives to consider real estate investment afresh.

Manufacturing activity in both the U.S. and **China** [the world's two largest economies] perked up in March, an antidote to financial-market fears of a coming global recession. The rebound in purchasing manager surveys in both countries and the growing perception that a trade deal between them may not be far off, sparked a rally in U.S stocks and a sell-off for super safe government bonds. That reversed a so-called inverted yield curve, in which short-term rates are higher than long rates, a precursor to past downturns.

The **EU** agreed to a three month extension for the effective date of the **UK's** exit from the regional block, amidst ongoing confusion among UK politicians over what terms should govern Brexit. It is apparent that the UK leadership was woefully unprepared once a Brexit vote was delivered. A "no deal" with the EU would probably be the worst outcome for the UK and companies have designed contingency plans to cope with the myriad of uncertainties that they will face once the UK finally leaves. Credit insurers are treading carefully and some are reportedly even cancelling cover over concerns that Brexit will exacerbate the increase in insolvencies in both the UK and Western Europe.

Asia currently finds itself at center stage of global economic activity. The continent is already home to more than half of the world's population. Twenty one of the world's largest cities are located in Asia and by next year it will be home to half of the world's middle class. Since 2007, Asians have been buying as many vehicles as the rest of the world combined. This shift makes Asia a leading, natural growth engine over the next decade. **India's** Prime Minister, Narendra Modi calls this the beginning of the Asian Century. According to the UN trade and development body, UNTAD, Asian economies will be larger than the rest of the world combined by 2021.

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According to the IMF Asia now accounts for 38% of global output, up from 26% in 2000. Behind the advance is the rise of **China** and India. China will account for 19% of global output in 2019, more than double the 7% recorded in 2000. India is now the third largest economy, with a GDP about double the size of either Germany or Japan.

Growth among smaller and midsized countries also contributed to the rise. **Indonesia** is on track to become the world's seventh largest economy, and will have overtaken **Russia** by 2023 as the sixth biggest. While **Vietnam**, one of Asia's fastest growing economies, has overtaken 17 countries in ranking of economies in purchasing power parity (PPP) terms since 2000, including Belgium and Switzerland. The **Philippines** is now a larger economy than the Netherlands while **Bangladesh** has overtaken 13 other countries in the past 20 years.

The dramatic rise of postwar **Japan** and **South Korea**, the first countries in Asia to catch up with the west, has been dwarfed by China's take-off following the country's introduction of market-oriented reforms in the 1970's. In just a couple of generations, a winning mix of integration with the global economy via trade and foreign direct investment, high savings rates, large investments in human and physical capital, and sound macroeconomic policies, contributed to Asia's leap forward. Significantly, Asia remains poorer than the west, but the gap is narrowing. China's GDP per capita in PPP terms is still only about one-third of that of the U.S., and about 44% of the European Union. India has a GDP per capita of only 20% that of the EU, according to IMF data. But India and China's GDP per-capita income gap with the U.S. and Europe has narrowed dramatically since 2000. Over that period, China has become nearly five times richer than the average per capita output of sub-Saharan Africa. The two regions were at similar levels in the mid-1990's. By any measure, Asia appears set to occupy center stage of the global economy into the next decade.

Meanwhile, political reforms in several emerging markets appear to be on a rocky path. In **Indonesia** and India where both leaders are broadly supportive of market reforms, polls indicate they are likely to be re-elected in April and May. India's President Modi is slipping in the polls as some of the shine has come off his reformist credentials.

In **South Africa** the African National Congress (ANC) looks secure for May elections, despite voter anger at corruption and continued frequent electric power blackouts. The economy remains depressed as investment inflows has dried up due to lack of confidence in government policies.

Argentina's presidential election due in October holds the prospect of unseating the pro-market reformer. However, even if president Macri is rejected, he will be replaced by Roberto Lavagna, who is also regarded as market friendly. The Macri reforms currently being pursued, would in all likelihood continue. Meanwhile, in March the peso came under renewed depreciation pressures, causing it to weaken to a new low. The economy continues to contract, interest rates have climbed and the outlook has dimmed since the beginning of the year.

In **Mexico,** business leaders appear unnerved by the behavior of Andres Manuel Lopez Obrador [AMLO] – the old school leftist who took office on December 1st last year. Bolstered by 80% approval ratings, AMLO has pushed ahead with proposals that resonate with voters, but have caused alarm among investors, who worry that overspending by the state will call into question the country's investment-grade credit

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ratings. After construction of a costly oil refinery was placed on hold by the Ministry of Finance, AMLO overruled that decision and doubled down on the project. Observers complain that AMLO has issues with delegating and projecting trust.

Events in **Brazil** are also unsettling. The currency slumped in late March. Many investors had been prepared to put up with highly insensitive rhetoric and attitudes of President Bolsonaro, the far-right and former army captain who took office on January 1st, on the grounds that his liberal economy minister will deliver on vital reforms to the welfare system. It is broadly accepted that Brazil needs to implement serious changes to its fiscal management if investor confidence and economic growth is to return. However, what markets were not prepared for is the extent of the new government's incompetence. Previously, investors were confident that that a broad desire and momentum for pension reform was sufficient to make it happen. Now, only a diluted pension reform is expected this year – as it is apparent that President Bolsonaro lacks the skills to negotiate with the president of the lower house of Congress, who is the single most important figure in steering through the welfare reforms currently before legislators. President Bolsonaro attacks against the congressional leadership could derail any real progress on reforms. The consensus among Brazilian experts is that failure to approve pension reform (which accounts for almost one-third of government spending) will crash the economy, which is attempting to end a four-year recession (the worst in six decades). For now, most observers expect Brazil to approve pension reform this year, albeit in a much diluted form. It is not certain that this will be enough to return the economy to growth. While it is early in the tenure of the Bolsonaro administration, markets and creditors continue looking for strong leadership on the fiscal front; and for signs that the new government understands how to build consensus needed to implement fundamental changes.

Turkey has drifted into recession and President Erdogan's Justice & Development party (AKP) is on track to lose control of the country's two largest cities in municipal elections. The AKP suffered defeat in Ankara, the nation's capital and Istanbul the financial center. The AKP is challenging the results. If confirmed, the loss would be a stinging blow to Erdogan's 16-year rule as it reflects the impact on voters of the lira's 30% devaluation, high inflation and the country's economic decline, which discourages foreign capital inflows.

These setbacks leave emerging market assets at the mercy of the U.S. Federal Reserve and its willingness to keep interest rates low [thereby continuing to provide cheap money]. Investors remain torn between exploiting short-term investment opportunities and being careful about the lack of high and inclusive growth in several countries. Growth continues to elude policymakers because reforms are either lacking or are being implemented too slowly. Emerging market investors are used to this scenario, of course: if it were not for the risk, they would not expect the reward. But it does put a question mark over the long-term growth expectation for many emerging economies. Especially in light of repeated downgrades to outlooks that have taken place this year.

China-Africa

Slower Chinese economic growth, tough business conditions, rising labor costs, industrial overcapacity and stringent environmental standards are taking their toll, causing Chinese entrepreneurs and investors to look abroad.

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Chinese companies tripled their investments in developing Asia last year in the latest sign of how the commercial landscape of the region is being reshaped by the ongoing trade war between Beijing and Washington. Data from the Asian Development Bank show that investment by Chinese companies in developing Asia soared to $54.9 billion in 2018, up 198% over 2017. The shift shows not only China's growing integration with a region that acts as its industrial supply chain but also a desire among Chinese companies to take cover from U.S. criticism by setting up factories in countries such as Vietnam, Indonesia, the Philippines, Bangladesh and others that have been hit by punitive U.S. tariffs.

The Chinese have also struck out to Africa. China's massive infrastructure projects overseas, including dams, railways, ports and telecommunications networks have captured most attention. Between 2000 and 2014, the stock of Chinese investments in Africa went from 2% of U.S. levels to 55%. McKinsey estimates that, at the current breakneck speed, China will surpass U.S. levels within a decade. Washington has belatedly woken up to China's growing presence in Africa which is transforming both the physical and diplomatic landscape of the continent. Recently the U.S. Administration accused China of using "bribes, opaque agreements and strategic use of debt to hold states in Africa captive to Beijing's wishes and demands".

According to McKinsey there are approximately 10,000 Chinese companies operating in Africa, including 920 in Nigeria and 861 in Zambia. The value of African industrial output handled by Chinese businesses amounts to $500 billion or 12% of the total. The IMF estimates that Chinese companies accounted for 9% of Nigeria's GDP in 2017.

Large companies such as Huawei, and big state-affiliated companies, such as China Bridge and Road, are not the only Chinese actors reshaping the continent. Instead, thousands of hardscrabble entrepreneurs involved in everything from retail to factories, to farming are having as big an impact as the big companies. The influence is reportedly particularly strong in manufacturing. Many believe that Chinese manufacturing investment is the best hope that Africa has to industrialize. Chinese involvement in Africa (and throughout the developing world) in not just about state-driven efforts. Just as large, if not a larger component are private enterprises, which are more labor-intensive, which localize quicker and which have a much larger economic and social impact.

Nigeria, like countries across Africa, has a huge infrastructure deficit. It lacks reliable power, water, and all-weather roads. A private Chinese group with interests in a variety of sectors (including coal mining, medicine, et al) has had to build from scratch in Nigeria's free trade zone. The company provided natural gas-powered generators and yet-to be paved roads connecting the free trade zone to the capital Lagos and beyond. The Nigerian government provided the land and the Chinese designed and spent their own money to build everything else. The result: an enclave of efficiency and stability in the country's notoriously unpredictable business environment. After seven years in operation, the free zone has 50 registered companies, including two ceramic manufacturers producing tiles and plates, a steel-pipe plant and factories making everything from furniture to tomato sauce. There's a printing business, a plastic recycling company and another specializing in construction materials. The Chinese investor anticipate expansion over the next 15-20 years to 10,000 companies in the free zone, 20 times the number today. The plans include different industrial sectors and different zones for electronics, construction, tiles as well as a research and development facility. According to the Chinese, Nigeria has conditions to become a factory to the world.

For now, the thousands of Chinese entrepreneurs in Nigeria have to contend with the present. Manufacturing contributes just 9% of GDP in 2017, according to the World Bank, and President Buhari – who was re-elected in February- has complained that Nigeria imports everything from toothpicks to tomato puree. Like other African countries, Nigeria's manufacturing ecosystem has withered since the 1980's, partly due to a poorly executed industrial policy that saw the state lavish billions on white elephant projects.

An irony of Chinese entrepreneurs setting up factories in Nigeria – and in other parts of Africa, such as Ethiopia and Rwanda – is that the import of cheap Chinese goods was another factor in destroying local production. Nigeria has also been hit by the oil export curse, which pushed up the exchange rate, making it cheaper to import finished goods than produce them.

The country's thriving textile industry is today a pale shadow of itself.

Because of a shortage of all but the most basic raw materials, most Chinese factories in Nigeria are limited to final assembly. They rely on imported parts and inputs, which means they need to access scarce foreign currency and coax supplies past sometimes obstructive port officials. Being creative has been a big help. Many Chinese buy Nigerian raw materials, such as timber and marble, which they export to buyers in China or Europe in exchange for Chinese renmimbi. Rings of Chinese money-changers specialize in matching those needing foreign currency with willing Chinese buyers of Nigerian imports.

Training Nigerian workers is a priority as many lack appropriate skills to operate some industrial machines. However, because local labor is cheap, packaging by hand is often a practical alternative for companies.

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