

## Major Country Risk Developments October 2023



By Byron Shouldton

### Overview

The financial crisis of 2007-09 began to weaken confidence in the old economic model of globalization. The global recession of 2020 further undermined the concept. During the pandemic, supply chains buckled, adding to inflation by raising the cost of imports. Hence, a system that had once seemed to deliver efficiency and convenience had turned into a source of instability. The benefits of globalization, constructed over the last five decades - were in doubt.

The pandemic further encouraged the belief that governments should do more. The role of geopolitics helped in further weakening confidence in the status quo. The U.S. and the West's increased sparring with China, using a variety of economic sanctions has played a central role. Then, Russia's launch of the biggest land war in Europe since 1945 went further. Gone is the notion that economic integration would lead to political integration between nations with different political systems.



The war on Ukraine led to an energy shock. Russia's weaponization of its hydrocarbon supplies has convinced many politicians and business leaders that they must secure alternative sources, not just of energy but of "strategic" commodities in general. And then, there is generative artificial intelligence (AI), which may pose a threat to workers. Together, these trends compounded a sense that the modern economy is stacked against the average person. By historical standards, inequalities of income and wealth are high.

As countries look inwardly, policy has moved toward protectionism or so called 'homeland economics' which seeks to protect the world from similar shocks in the future. It seeks to keep the benefits of globalization, with emphasis on efficiency and low prices, but to avoid the downsides: the uncertainty and unfairness of the previous system. This requires meshing national security and economic policy.

Much has changed since the hyper-globalization of the 1990s. The U.S. has signaled that control of the economy had shifted to the geo-strategists. The European Union (EU) boasts it is the first major economy to set out a strategy on economic security. France sees the need for "strategic autonomy," and India's prime minister has embarked on economic "self-reliance."

To achieve these goals requires reaching back into the historical toolkit. Some, following the protec-

tionist policies of the 1930s and the U.S. in 2018, are raising tariffs. Others are spending on R&D, hoping to recreate the government-funded research labs of the 1950s that helped win the Cold War.

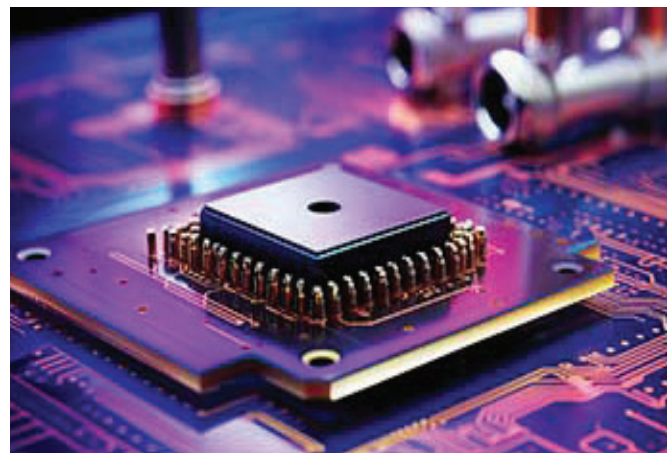
Drawing on the European experience of the 1950s and 1960s, many governments are hoping to build up national champions in strategic industries—not coal and steel, as before, but computer chips, electric vehicles, and AI. They are implementing huge subsidies and domestic-content requirements to encourage production at home. Critics of globalization contend that the gains of open trade failed to reach a lot of working people—best, therefore, to limit it. As in the Cold War, Western governments are using economic tools to weaken geopolitical adversaries, including bans on exports and international investment, especially when it involves “dual use” technologies, for civilian and military applications. They have also pledged massive support for clean technologies in the fight against climate shifts.

The U.S. implemented the Chips Act, to help the domestic semiconductor industry, and the Inflation Reduction Act (IRA), which has less to do with inflation than with subsidizing green energy. Both look to build up domestic employment and expertise. Both cost a lot. About 40% of all rich-country spending to support clean energy comes from the U.S. But other countries are also spending big.

The EU has responded to the IRA, launching its Green Deal Industrial Plan. It has its own version of the Chips Act. Recently, 14 EU member states set up a scheme to support microelectronics and communication technologies. France is launching a fund to produce critical minerals. The EU wants 40% of key technologies needed for its green transition, and 20% of the world’s semiconductors, to be made in

the bloc.

India has set up a “production-linked incentives” scheme for many sectors, including manufacturing of solar photovoltaic modules and advanced batteries. Under the K-chips Act, South Korea offers tax breaks to semiconductor firms. Taking inspiration from the “Made in China” scheme begun in 2015, there is now “Made in America,” “Made in Europe,” “Make in India,” “Made-in-Canada plan” and a future “Made in Australia” in the making.



Researchers are quantifying these trends. A new paper, by the University of British Columbia, Oxford University, and Boston University, tracks industrial-policy interventions over time. The study found a surge in 2021 and 2022. In contrast to the past, when poor countries used industrial policy as a development tool, now rich countries have the lion’s share of industrial policies. According to study, interest in industrial policy is soaring.

Money is sloshing around in huge quantities, as governments try to persuade companies to locate or expand activity in their country. In the first quarter of 2023, the EIU estimate is that firms across the

rich world received about 40% more subsidy cash than was normal in the years before the pandemic. In the second quarter, the U.S. spent \$25 billion on subsidies. Governments in seven big economies have earmarked up to \$400 billion for the semiconductor industry over the next decade.

Since 2020, governments have allocated \$1.3 trillion to support clean-energy investment. The U.S. spending on industrial policy, relative to GDP, is likely to remain some way behind China, but it is already rivalling that of France. Britain’s Labor Party, if it wins power, plans to lavish billions on green handouts which, as a share of GDP, would be ten times more than the U.S. According to a leading advocate “the project of the 2020’s and the 2030’s is different from the project of the 1990’s.” Over time, the new industrial policy is likely to expand. Policy-makers are turning their attention to AI and quantum computing as top priorities.

Corporations are responding to the changing political winds. On earnings calls, executives have re-

portedly mentioned “reshoring” production to their home countries more frequently. Others say they are moving from “just in time” to “just in case.” This means keeping higher stocks of raw materials and finished goods, which can be drawn on if supply chains fail. Other companies are leaving China, re-locating elsewhere.

Investors think there is more to come. Since the start of 2022, the average share price of U.S. firms perceived to benefit from additional infrastructure spending rose by 13%, compared with a 9% decline for the overall U.S. stock market, according to data from Goldman Sachs. Silicon Valley investors are going all in. Under an “American dynamism” initiative, some venture-capital funds are promising to back founders and companies that support the “national interest.”

A lot about ‘homeland economics’ or protectionism sounds reasonable. No one can oppose making supply chains resilient, helping left-behind regions, rebuilding energy structures and standing up to



China. There are strong theoretical and economic justifications for industrial policy. These policies will create many winners, from the bosses of firms receiving payouts, to investors in those firms, to local areas which benefit from a new factory.

However, the new report shows that ‘homeland economics’ will also create losers. Beneath the apparent reasonableness, there is a deep incoherence. It is based on an overly pessimistic reading of neoliberal globalization, which in fact created great benefits for most of the world. The benefits of the new approach remain uncertain. Meanwhile, attempts to break free economically from China are likely to be partial, at best. The benefits of green subsidies for the fight against climate shifts are also less clear, even while appearing reasonable.



The costs, by contrast, are huge. Research by the IMF considers a hypothetical world which has split into U.S. and China-led blocs (with some countries remaining unaligned). In the short run, global output would be 1% lower, and in the long run 2% lower. Other estimates put the likely global GDP impact at 5% lower. The historical experience of industrial policy is not encouraging. Governments are going

to waste a lot of money—which is not a good plan, given the demands from health care and pensions, and already-large deficits.

Drawing on analysis from a range of mostly rich countries, this new report argues that ‘homeland economics’ will struggle to make supply chains more resilient and is unlikely to help the economy over the longer stretch. It argues that the new policies will do little to reduce inequality, and not enough to deal with climate change.

Faced with these findings, believers in market economics nonetheless face an uphill struggle. The benefits of the new economic model, however concentrated and partial they may be, will be easy to see and therefore politically salient. Governments are already boasting about the successes of their subsidy regimes—whether it be Tata’s new automotive battery plant in the UK (rumored fiscal cost: \$612 million), or the new Rapidus chipmaking plant in Hokkaido, Japan (with billions of dollars’ worth of support from the Japanese government).

Still, many believe that in ten years the West will probably be roughly as reliant on China as it is today, and as unequal and as slow growing.

## USA

The U.S. economy, the world’s largest, is primarily driven by private consumption, which makes up nearly 70% of GDP. The U.S. is less reliant than other G7 economies on external demand, sheltering it somewhat from external shocks such as the war in Ukraine. The U.S. congress is evenly divided, with Republicans controlling the House of Representatives while the Democrats are narrowly in control of

the Senate. Partisanship and polarization will weigh on political stability, particularly ahead of the 2024 elections.

The U.S. Federal Reserve (the Fed) kept its policy interest rate unchanged at 5.25-5.5% in September. In its last four meetings, the Fed has alternated between raising and holding rates as it proceeds cautiously in the final stages of its tightening cycle. The latest projection expects one more rate increase in 2023. They also point to a slower pace of easing in 2024-25 than was previously anticipated. The consensus is that rates will remain high for a longer period. U.S. financial markets have pushed back their expectations for when the first rate cut is likely. Some expect easing to begin in July 2024. This is expected to have a dampening effect on economic activity, including high mortgage rates, tighter lending standards, and sustained risks to banks' balance sheets. These factors are expected to weigh more heavily on consumer spending in the year ahead.

Private consumption is forecasted to contract slightly in the 4th quarter of 2023, and to register only a tepid recovery in the first half of 2024. Assuming that the Fed starts to lower interest rates in July 2024, consumer spending will likely pick up pace in the second half of that year.

We expect U.S. economic growth to slow in early 2024, as still-high oil prices and the steep rise in interest rates over the past year start to weigh on demand. GDP growth will likely follow these trends, with growth of around 2% in 2023 and less than 1% in 2024. The Fed is more optimistic, projecting growth of 2.1% in 2023 and 1.5% in 2024-with the consensus expecting a soft landing for the U.S. economy, with only a modest rise in unemployment and a gradual deceleration in price growth over the next

twelve months. Thus, far resilient consumer spending has offset the impact of a slowdown in manufacturing on overall GDP. However, several factors suggest that the pace of consumer spending will soon slow. Rising household debt has increasingly supported the spending boom, and this is unlikely to continue over the long term. Growth is projected to ease in the first half of 2024, before picking up in the second half once interest rates start to fall. We expect growth to average 2% per year in 2025-27, assuming that inflationary pressures have subsided and that interest rates gradually return to neutral.



Western policymakers have become increasingly concerned about depending on geopolitical adversaries for the supply of commodities following Russia's invasion of Ukraine and the ratcheting up of tensions between the U.S. and China over Taiwan. The U.S. introduced the \$369 billion Inflation Reduction Act in 2022 to galvanize efforts to reduce reliance on Chinese supply chains for clean energy technologies.

The U.S. Departments of Energy and Defense have poured billions of dollars of subsidies into accelerating the establishment of mines and processing facilities domestically. But, shifting to electric vehicles and renewable power requires vast quantities

of lithium, copper, and nickel. Meeting demand, while reducing reliance on China, would require significant investment from the slow-moving mining industry to boost supply. Copper alone requires \$250bn of growth capital by 2030 to meet demand.

The U.S. has been spared an influx of Chinese cars due to a number of factors, including tariffs of 27.5% on cars, while Chinese vehicles are ineligible for the consumer EV tax credits under the Inflation Reduction Act. These put Chinese made vehicles at a disadvantage in the U.S. market. Furthermore, geopolitical tensions seem to have steered Chinese auto manufacturers away from the U.S. market – at least for now.



Global hydroelectric generation is forecast to decline by approximately 2% in 2023. Hydroelectricity is the world's largest source of clean energy, so the growing incidence of droughts and high temperatures, exacerbated by climate shifts, is increasing the energy risks for countries. This will result in the need to fill the gap with fossil fuel-based power generation. Although the fall in hydropower in 2023 is expected to be temporary, the increased frequency

and intensity of extreme weather events represents a growing risk going forward.

The foreign policy priority is Russia, the war in Ukraine, adequate global energy supplies and the combined China-Russian threat to the status quo. Despite the U.S. pledge to continue providing military support to Ukraine against Russian aggression, resistance from fiscal hawks in Congress could seriously squeeze future funding. With the attack by Hamas on Israel, stability in the Middle East is now back on the frontlines of global security concerns.

## Brazil

Inflation has rebounded in Brazil, but the consensus expects it to cool in the year ahead. After cutting its benchmark Selic rate by 50bps, from 13.25% to 12.75%, in September 2023, the Central Bank of Brazil (BCB) is forecasted to continue its easing cycle over the coming quarters. We expect to see the Selic rate down at 11.75% at year-end 2023 and 9.25% at end-2024, as inflation edges lower in 2024, but remaining slightly above the central bank's 3.0% target.

Risks for 2024 are towards higher rates, given the relative strength of the Brazilian economy, a robust labor market, rising oil prices and the Fed's increasing hawkishness. The BCB will continue its easing cycle in November 2023 with a third-consecutive 50bps cut. The uptick in inflation largely reflects base effects, particularly in transportation prices, marking a high point before inflation resumes a downward trajectory. Inflation is projected at 4.9% at the end of 2023, roughly in line with the consensus in the BCB's survey of economists.



Risks to the forecast for 2024 are fewer rate cuts than we forecast. This is for a few reasons. First, economic activity could continue to surprise to the upside, potentially boosting demand pressures. Second, risks to oil price forecast (\$80 per barrel in 2023, and \$100 per barrel in 2024) have increased, which will keep transportation prices elevated. Also, the BCB may be more concerned about inflation expectations remaining above 3.0%. In addition, the Fed could keep rates even higher than anticipated in 2024, which would raise the risk of weakness in the Brazilian real that would influence the BCB to keep rates higher.

Economic activity is expected to decline further over the coming months, as the aggressive 2021-22 monetary policy tightening cycle takes fuller effect and the impact of Brazil's early 2023 bumper har-

vest wanes. President Lula da Silva took measures in 2023 to spur the economy, including a rise in minimum wage and increasing the lower threshold for exemption from income tax. The government's fiscal stimulus has further buoyed demand, particularly among poorer households, helping the resilience of the services segment.

Brazil's stronger results in the second quarter of 2023 led to a revised GDP growth forecast for 2023, from 2.4% to 3%. We expect elevated interest rates to weigh on economic activity through 2024, causing real GDP growth to slow to 1.6% next year. This anticipated economic slowdown will keep business confidence relatively muted. The government's intention to strengthen the public finances and its commitment to growth-enhancing reforms will help to prevent a sharper deterioration in investor sentiment.

A cabinet reshuffle that followed weeks of negotiations between President Lula, his key ministries and two right-wing opposition parties, the government awarded the heads of two ministries (previously held by Lula's Workers Party) to the right-wing opposition. This was meant to boost Lula's ability to pass legislation.

With this enlarged coalition President Lula has a stronger platform for advancing tax simplification reforms and an imminent income tax reform. He also wants his new partners to approve a recent temporary presidential decree that taxes offshore entities. Even so, the president will have to negotiate with legislators on the details of reforms and will often encounter pushback, particularly ahead of the October 2024 municipal elections, which usually complicates legislative successes.

## Ecuador

Political risks are rising, given violent gang warfare involving the transnational drug trade. A leading candidate for the presidency was assassinated in August as he left a campaign rally. For Ecuador, a country that has in the past been known for its relative calm in the region, the killing has been especially shocking. The possible motives of the killing, which is believed to be the work of an organized criminal group averse to the murdered candidate's tough position on crime and security, are not hard to discern.

The assassination was an astonishing statement of how far Ecuador has descended into lawlessness. During 2023, there have been a number of other political killings. The attacks have spread from the coastal cities, where the drug trade is concentrated, to the heart of the capital Quito, with a car bombing in late August.



The uncertain outcome of the elections due on October 15, a soaring sense of insecurity, and an

economic slowdown have combined to negatively impact current perceptions of Ecuador. How the incoming president handles the situation could have far-reaching consequences.

Still-high oil prices have reduced fiscal imbalances, but the market-friendly agenda of the outgoing president, Guillermo Lasso, including boosting private-sector investment and making labor regulations more flexible, has waned. The public administration will likely remain inefficient and overrun by vested interests. Transparency and politicization issues in the legal system will linger. Dollarization, in place since 2000, will aid price stability but undermine Ecuador's competitiveness. Despite improvements in infrastructure, road and electricity networks will remain deficient.

Dollarization has improved market confidence following a systemic collapse 1998-99, and banks have gradually re-established their credibility as financial intermediaries. Public confidence in the banking system has also improved in recent years, but credit will remain scarce for most businesses, partly owing to lending rate ceilings. Having been overcrowded, the market is now dominated by four big banks and suffers from a lack of competition. Credit availability is stunted, because private banks must maintain high liquidity levels owing to the absence of a lender of last resort in the dollarized financial system. Most deposits are in instantly accessible current accounts, so a dip in confidence in the financial system could prompt a run on these deposits. Moreover, laxer financial regulation on co-operatives, savings and loans associations, and community banks sustains macroprudential risks.

The outgoing government has secured closer economic ties with the U.S., Ecuador's second-largest





trading partner. It has also signed free-trade agreements (FTAs) with China (its largest partner) and Costa Rica, but these must still be ratified by the legislature.

The outgoing government has also actively negotiated other trade deals and is seeking Ecuador's accession to the Pacific Alliance, a regional trade bloc. Nonetheless, given expectations of a shift towards the left in the election, the expectation is that the country's trade liberalization agenda may end.

Regressive trade measures have been applied throughout Ecuador's history, either to raise revenue or in response to protests from local producers. There is a risk that the new government will adopt such measures should it face political pressure. Competitiveness issues resulting from the U.S. dollar's strength will persist, given the lack of structural reforms to boost productivity or lower regulatory

costs.

Ecuador's infrastructure improved dramatically amid high public investment under a former president, Rafael Correa (2007-2017), albeit from low levels. In particular, road, maritime and power infrastructure improved, but fiscal challenges in the past years have dried up public investment for new projects. The power supply is vulnerable when water levels fall too low. Buying power from Colombia and Peru, using new interconnection lines, will offer a way of overcoming shortages but will be costly. In the telecommunications industry, infrastructure is poor and mobile penetration remains below regional standards.

New airports were opened in Guayaquil in 2006 and the capital, Quito, in 2013, but taxes on the industry have weighed on the sector's development. A long-delayed planned metro line in Quito is expect-

ed to be fully operational by end-2023. The road network has been extended in the Amazon region and is being gradually improved and upgraded in the central and coastal areas.

The Ecuadorean judiciary is highly politicized, and bribery remains a major problem. Property rights are protected by legislation, but enforcement is weak. Although a long overdue anti-trust law will help in eroding the monopolies that exist in some sectors of the economy, it has raised concern over the discretionary powers of the president. Regulators are subject to political pressure.

There are barriers to foreign competition, and many foreign investors have received unfair treatment in the past. Intellectual property protection is improving, but serious deficiencies remain. The 2008 constitution changed the make-up and hierarchy of the courts (the Supreme Court is now called the National Court of Justice and is subordinate to a new Constitutional Court), but increased confusion and further politicized the judicial branch. A constitutional reform adopted in 2018 partly reduced the subordination of the judiciary to the executive, but politicization continues to be a significant problem.

Port security in Ecuador is lax. In Guayaquil, the full installation of electronic scanners, used in many international ports to detect contraband and drugs, has been held up by various poorly explained delays, leaving a team of dogs to do their best to sniff out illicit substances. Criminal forces have also shown no mercy in forcing port workers to work for them. One port worker who, in August, reported to his family that a drug trafficking group was pressuring him to smuggle drugs into loading areas, was found dead with four other co-workers shortly thereafter.

## Turkey

President Recep Erdogan won the tightly contested presidential election run-off in May 2023. The alliance led by Mr. Erdogan and his Justice and Development Party (AKP) controls a majority in parliament, which will improve political stability but also allow Mr. Erdogan to continue to dominate both domestic and foreign policies over the coming years.

We expect GDP growth to slow to 3.2% in 2023 but improve in 2024 to 4%. The focus in the short term will remain on the reconstruction efforts following the massive earthquakes that hit Turkey in February 2023. So far progress has been slow. Meanwhile, the dismantling of the irrational economic program started five years ago has started but will take time.



Poor policy choices have put Turkey at a disadvantage relative to other emerging markets, with high external financing needs, which will remain high in 2024. The Central Bank of Turkey (CBT) started to increase its main policy rate in June, mark-

ing the beginning of an expected shift towards more orthodox policies. This follows two years of irrational policymaking built around Mr. Erdogan's preference for ultra-low interest rates, despite high inflation and prolonged currency weakness. A new economic management team, appointed in June 2023, has gradually started adopting tighter, more orthodox policies.

As part of this process, the CBT's policy rate-which had been reduced to just 8.5% before the May 2023 elections-has been gradually increased. The policy rate remains far below current inflation (which reached 60% in August) and inflationary expectations for the coming months. However, the gap between bank interest rates and inflation is starting to close. Credit rates are being set way above the central bank rate while lira deposit rates have already risen to 25-40% as a result of a favorable tax arrangements and reserve requirements, as well as the targets imposed on the banks for reducing the

share of foreign-currency accounts in total deposits and raising the share of lira deposits. As a result of the CBT decision, the maximum interest rates permitted on commercial, investment and export credits and on consumer credit cards and overdrafts will rise automatically. Higher credit rates will make it possible for banks to increase their lira deposit rates.

The forecast is that the policy rate will reach 37.5% by year-end 2023, rising further in early 2024 before rate cuts begin later in 2024 as the depreciation of the lira starts to slow and headline inflation starts to fall. However, as the central bank still lacks independence, there is a risk that policy tightening may not be politically acceptable, particularly if GDP slows by more than forecast.

In these circumstances, credit-driven consumer spending is likely to decline, helping to reduce inflationary pressures and temper the current-account deficit. However, the support that the rate increase



will lend to the lira will be limited. Rates may still be too low to persuade large numbers of savers to stop saving in dollars and other foreign currencies. In addition, government bond yields held down by obligations on banks to buy low-yielding fixed rate bonds will remain unattractive to foreign investors.

Economic activity during the first half of 2023 was supported by the election campaign benefits handed out by the administration. Public spending (including earthquake reconstruction) will continue to support growth over the next few years, but underlying economic distortions will prevent firmer growth. The consensus projects a managed depreciation of the lira against the U.S. dollar. The lira will weaken at a slower pace in 2024 and beyond owing to factors including internal and external imbalances.



Other policies to be used in the fight against inflation include income restraint and efforts to combat inflationary expectations and the backward linkages of pricing decisions. Overnight success is not expected: consumer price inflation is slated to come down to 33% by the end of 2024. Our central forecast is that the orthodox policies will be implemented, especially given that only local govern-

ment elections (in March 2024) are due before 2028. However, there is a high risk that Turkey will have to implement these policies more stringently than it anticipates, to cut inflation and improve external imbalances. In particular, interest rates may have to rise steeply, and stability may only be achieved at the cost of lower GDP growth.

In addition, the performance of the economy is likely to show considerable volatility from year to year depending not only on policy implementation but also on global financial conditions, global and European growth, international commodity prices and geopolitical developments. Turkey is a key player in global commodity trading especially as a third country for Russian oil and metals trading with Europe, Asia, and the Middle East. The sector has blossomed following imposition of EU and western sanctions on Russia because of the war on Ukraine.

Trade of Russian crude, copper, zinc, aluminum, metals, fertilizer inputs and other raw materials have reportedly avoided sanctions by being routed via Turkey. The trades underline Europe's dependency on Russia for critical commodities as well as the growing role of Turkey as a transshipment hub. It also highlights the key role of middlemen in facilitating continued importation of Russian commodities into Europe despite existing sanctions. Turkey serves as the staging point for Russian metals, copper, and other raw materials enroute to Europe while volumes tripled in 2023.

In the second half of 2023, Turkey's unemployment rate fell to 9.7% and the full year figure has been revised to 10.2% from 10.6%. The expectation is for continued weak employment growth in 2024 due to economic uncertainty and belt tightening. However, tourist arrivals in Turkey are rebounding

solidly (except for a pullback following the 2023 earthquake). The expectation is that global visitors to Turkey’s historic sites will rise steadily over the 2024-27 period, lift employment in the hotel, leisure, and transportation sectors, lifting Turkey’s foreign exchange earnings.

Turkey’s foreign policy choices have often conflicted with NATO interests and are increasingly clashing with those of the U.S. and the EU. However, there are expectations that Turkey, the U.S., and the EU will continue to pursue a pragmatic and transactional relationship going forward.

## China

The Chinese economy is showing signs of perking up after months of anemic growth, offering a glimmer of hope for the global economy as higher interest rates squeeze consumers and businesses in the U.S. and Europe. The forecast for growth in 2023 is now 4.9% [down from 5.3% previously, and 4.6% in 2024 [down from 4.9% forecast previously]]. The World Bank downgraded its growth forecast for China from 4.8% to 4.4% next year and for the broader set of developing economies in east Asia and around the Pacific from 4.8% to 4.5%.

The country, one of the world’s main growth engines, is now likely to experience the slowest pace of improvement since the late 1960s, barring extraordinary periods around the pandemic, the 1970s oil shock and the Asian financial crisis.

Chinese factories in September 2023 reported the first expansion in activity since the spring, while railway and flight bookings point to a bumper period ahead for tourism as China takes a break to cele-

brate its weeklong National Day holiday.

The economy is far from being in full health, and it is too early to say if a major turnaround is ahead. A big problem is real estate. A drawn-out downturn in the real estate sector shows few signs of abating and troubles at major property developers are mushrooming. For example, China’s largest developer is under investigation by the authorities for potential criminal wrongdoing and for owing tens of billions of dollars to lenders, contractors and suppliers, which it cannot repay. Regulators have also blocked parts of the company’s turnaround plan, an ominous signal for other developers flirting with insolvency.

New home sales at China’s largest developers fell 29% in September from a year ago, despite major rule changes that made it cheaper and easier for more people to purchase homes. The large year-over-year decline in September home sales indicates a housing recovery is still a long way off.



The economy faces other challenges. Exports are shrinking and tensions with the U.S.-led West are simmering over issues including trade and technology. Local governments across China are straining under high debt loads. Economists believe Beijing will need to step up its stimulus efforts to underpin a stronger and more durable recovery. The consensus view is that more stimulus measures will be necessary.

The gauge of activity in the manufacturing sector rose to 50.2 in September 2023, from 49.7 in August. This is the first time since March that the purchasing managers' index crept over the 50 mark that separates expansion from contraction. A similar gauge of activity for non-manufacturing sectors of the economy rose to 51.7 from 51, spurred by consumer spending on eating out, travel and other services. Construction activity also expanded at a faster clip, aided by a government push on infrastructure.

Indications suggest holiday celebrations at the beginning of October was a bumper one for tourism in 2023. The Civil Aviation Administration of China reported 190 million commuters via train and another 21 million people on domestic and international flights. The number of international flights operating during the holiday was 18% higher than in 2019. The number of passengers traveling by train on the first day of the holiday topped 20 million for the first time in history.

The latest data suggests improving trends following months of weak readings. Data for August showed consumers spent more freely on cars and smartphones and splurged on summer travel, helping to push inflation back above zero after consumer prices posted a year-over-year fall in July. The urban unemployment rate edged down in August for the first

time since April, while banks lent more freely. This new data points to a healthier second half of 2023 for the economy after a difficult first six months. After staging a first-quarter rebound following the lifting of Covid-19 restrictions, a consumer-led recovery in China quickly fizzled and a weakening global economy began to dent exports. Growth in the second quarter came in at just 0.8% when compared with the first three months, one of the weakest such growth rates in years.



The Chinese government and the central bank have announced a variety of smaller-scale stimulus mea-

asures to beef up confidence and improve growth. Efforts are aimed at stabilizing the teetering housing market, with cuts to interest rates and down payment requirements on mortgages designed to spur borrowing and help restore faltering consumer confidence.

The broad consensus is that more is needed to prevent growth from flickering out again. The government will likely be compelled to take direct steps to boost consumption, including offering households tax breaks or handing out cash or vouchers for consumers to spend. High inventories in advanced economies (notably the U.S.) and monetary and fiscal tightening around the world have weakened demand for China's goods exports in 2023 and likely into 2024, even as the country's manufacturers gain global market share in segments such as industrial machinery, petrochemical products and automotive. Goods import volumes will turn positive as do-

mestic demand recovers. China's large current-account surplus will persist throughout 2024-2027, averaging 1.8% of GDP.

Overall, the Chinese economy seems to be heading for a difficult few years. Beijing appears determined to nudge the economy away from a growth model driven by property-led investment and toward one powered instead by advanced manufacturing and other sources of what officials call high-quality growth. The adjustment could be painful. The transitional period could be challenging as the economy grows at a slower-than-expected rate. Nonetheless, a successful rebalancing of the economy would ultimately put China on a healthier economic footing in 2026-27.

Rather than pursuing a single-minded focus on GDP growth, policymakers in China have increasingly pushed for a mix of other agendas. National



security will command a paramount position in China's policy agenda over the next four years. The country is seeking greater self-sufficiency in advanced technologies and supply diversification in agriculture and energy. In response to tightening export controls in the U.S. and its allies, the authorities will divert resources towards domestic research and development.

The U.S. Department of Energy has warned that transitioning from fossil fuels will make energy security infinitely more complex because of China's stranglehold on the processing of the critical minerals essential for renewable power. China dominates the cobalt, rare earths, and graphite industries, which are vital for renewable energy, electric cars, and defense technologies. China's global market share for the refining of each of those three materials exceeds 70 per cent. In the context of critical minerals, the U.S. and the West are up against a dominant supplier that is willing to weaponize market power for political gain. The fuel of the energy transition - critical minerals - is set to make global energy security more complex and infinitely more important over the coming decades.

The EU has initiated an investigation of Chinese subsidies amidst charges of unfair trade practices in the electric vehicle sector. Over the past decade, the Chinese EV industry has benefited from massive state subsidies and other government support. This paved the way for China to become the largest global vehicle exporter in 2023, surpassing Germany and Japan.

Moreover, China has strategically secured critical mineral deposits around the world needed for battery production, such as lithium. That means for several years Beijing has been able to dictate that EV's

use Chinese-made batteries, which account for 60% of the value of a car. While China has the world's largest domestic automotive market at some 26 million vehicles, its EV companies are producing way more than the domestic market can consume - an excess of as much as 10 million a year.

In many respects, the EV playbook looks similar to those followed by Beijing in developing its solar, steel, and aluminum sectors. In those industries, massive subsidies led to overproduction and excess supply, saturating global markets and crippling international competitors. The oversupply of EV's has already found its way to Europe and other corners of the world.

China has displayed a willingness to politicize supply chains, introducing restrictions on key chipmaking materials gallium and germanium in response to Dutch plans to limit sales of high-end semiconductor manufacturing equipment to Chinese firms. As a result, the EU is in the process of finalizing critical mineral partnership deals with Australia, Democratic Republic of Congo, and others in a bid to diversify critical mineral sourcing. Despite attempts by the U.S., the EU, and other advanced economies to spur domestic manufacturing in green technology, China's lead in many of these areas, particularly solar, wind and battery technology, will see it remain a key supplier for the technologies powering the green transition for at least the next decade.

*By Byron Shoulton, FCIA International Economist  
For questions / comments, please contact Byron at  
[bshoulton@fcia.com](mailto:bshoulton@fcia.com)*



A Trusted Leader In Trade Credit Insurance!