



MAJOR COUNTRY DEVELOPMENTS

September 2009

Overview

The global recession appears to be easing led by **China**, the **US**, **Germany** and **France**. Second quarter gross domestic product (GDP) results were good in these major economies. The rebound is being supported by strong government stimulus packages, which should have even greater impact over the next several quarters.

Still, a sustainable global recovery is not a foregone conclusion. There are problems weighing on demand. Unemployment will continue to climb for some time globally. At the same time, the global banking system remains undercapitalized. Access to credit will remain tight, restricting finance to consumers and businesses. For companies needing credit the most, the options are limited and when available, it is very expensive. There is the possibility of a double-dip recession if governments are not careful about raising taxes and interest rates and how quickly they exit from the stimulus measures that were implemented to battle the worst global recession since World War II.

Little progress has been made, so far, in rebalancing the world economy. Corporate defaults reached 10.7% worldwide in June the highest rate since 1991. Projections are that by the fourth quarter defaults will rise to 12.2% globally. Credit markets that started to freeze in August 2007, have now triggered more than \$1.5 trillion in write-downs and losses at the world's biggest financial institutions.

In several countries where consumption helped power the boom, over-indebted consumers are suffering balance sheet recessions. It appears unlikely that resumption in spending, when it occurs, will be anywhere close to pre-recession levels. Although rising unemployment and weakened banks remain a threat to the global economy, the new dynamism in manufacturing in a number of countries is creating some optimism that a sustained recovery could eventually follow. For now however, it is uncertain if this is only a short term pick-up, as inventories have now been reduced allowing supply chains to restock in anticipation of renewed demand. For the global recovery to be sustainable, a period of consistent demand from countries other than the US will be necessary. That would include **Japan**, **Germany**, and **China** who have not been big spenders in the past. Evidence of that shift is gaining momentum in China, Germany and a bit more modestly in Japan. **Japan's** GDP grew by 0.9% in the 2nd quarter, an annualized rate of 3.7%. Exports strengthened and a rise in consumer spending offset weakness in Japanese housing sector and business investment.

USA

The evidence in the **US** is that consumers are mostly paying down debt, restricting purchases to necessities and have resumed saving. The US savings rate is now at a 14-year high of 6.2%, a dramatic reversal from the negative savings rate just prior to the recession. Similar to consumers, companies are hoarding cash, wary of losing access to capital. One exception to this trend has been the "cash for clunkers" program, which successfully convinced enough Americans to trade in energy inefficient autos for new energy efficient ones. The government provided the incentive by offering generous cash for the old vehicles. The program has now been concluded but managed to create some activity in the mostly stagnant auto sector. The bump in auto sales helped in pushing the Institute for Supply Management's index measuring manufacturing activity above 50 for the first time in 19 months. This boundary marks the point between contracting and expanding economic activity. US manufacturers apparently experienced greater demand from carmakers following the cash-for-clunkers program. They report that a sudden surge in demand created a shortage of raw steel. After 18 months of decline, manufacturing output is coming back with 11 out of 18 manufacturing industries reporting growth.

Confidence is improving. The housing market seem to be slowly recovering with new home sales up in five of the last seven months as buyers take advantage of low interest rates, a federal tax credit and bargain prices. Still, without the government incentives it is questionable how strong a push there will be for big ticket purchases in the months ahead. Retailers report only lackluster sales in back to school shopping which is usually a precursor to the year-end holiday shopping season.

Unprecedented steps by the US government and the Federal Reserve halted the slide as they spent, lent or committed \$12.8 trillion toward reviving the economy.

As a result, forecast for the US budget deficits was revised to \$9 trillion over the next decade (up from \$7 trillion previously forecast). One concern is that with the proliferation of US debt, the influence of the US dollar will likely weaken going forward. Not only is it uncertain how the dollar will perform against certain foreign currencies, but the huge US deficits will likely fuel inflation as the cost of US imports rise in dollar terms. According to recently released data, only a small percentage of the \$787 billion stimulus package has been spent thus far. This means that the potential for a gradual pick up in momentum is a real possibility as the rest of the stimulus funds begin making its way through the economy in 2010.

Two areas of concern remain unaddressed and have the potential to hurt the economy going forward. These are debt servicing in the commercial real estate sector and the stability of small and mid-sized banks. There is growing evidence that the weakened state of leasing in office towers and other commercial property is having serious consequences for the holders of mortgages in these buildings. The owners and operators of numerous buildings across the country are having difficulty servicing their mortgages due to loss of tenants and a glut of available commercial space sitting idle. Some properties have remained vacant or partially vacant for extended periods, generating no or little income. And, while the health of several of the larger banks have been somewhat stabilized, many smaller institutions remain vulnerable. Both of these issues could become larger problems in the coming months, hitting confidence and impacting the pace of or delaying a full recovery.

Euro-zone

In the 16-nation **Euro-zone**, bank lending to businesses was squeezed further in spite of signs of recovery. Instead of borrowing, the evidence shows that businesses repaid \$37 billion in loans, slightly less than they paid in the previous month. This strengthens the view at the European Central Bank that the rebound remains fragile. Loans to households have shown no growth over the year so far.

Still, purchasing managers indices in **France** and **Germany** showed the fastest rates of improvement. The French index rose to 50.8 in August, which is the first time it indicated any expansion since May of 2008. The German purchasing manager's index went from 45.7 to 49.2 in August.

Also, the GfK research institute is projecting that German consumer sentiment will improve to its highest level in 15 months. The mood of German shoppers is being helped by relatively stable employment (unemployment is at 8.3%, mostly unchanged from July) and falling prices-although German inflation data revealed that the country's brush with negative inflation ended earlier than expected. In spite of the pick up in economic activity, the risk of a weakened banking sector acting as a constraint on growth remains a serious concern for policy makers. Germany's exports, which were badly hit by the collapse in global confidence that followed the downturn last year has shown improvement since June. Orders from abroad continue to increase which for Germany is a leading indicator that a boost in output may be sustainable.

Nigeria

Nigerian banks that were considered to be in need of capital to boost their balance sheets received such a boost (\$2.6 billion) from the central bank. Following an ongoing audit of the country's 24 banks by the new governor of the central bank, 5 banks were found to be in acceptable shape while another five were categorized as being in need of support. While the banks will continue to operate, the managements of these institutions which were found to be overexposed were immediately removed from their posts. The central bank agreed to guarantee the foreign loans and correspondent bank lines of the five banks, which are considered 'systemically important' as they account for more than 5% of assets and deposits in the Nigerian banking system. The five banks receiving the capital boost are: Intercontinental Bank Plc, Afribank Nigeria Plc, Union Bank of Nigeria, Oceanic Bank International Plc and Finbank Plc.

The audit found that management at these named banks had acted against the best interest of the depositors and shareholders. The bold action by the central bank is aimed at preventing a loss of confidence in the nation's banking sector. There are 14 banks for which audits have not yet been completed.

The central bank went further by making public a list of prominent individuals and CEO's at several companies who are among the largest bad debtors to the banks, owing a total of \$4.71 billion. They were declared in default, ordered to pay up or face arrest. Two CEO's have already been arrested.

Meanwhile, the government offered amnesty to rebels operating in the Niger Delta region, hoping this will bring an end to many years of conflict including frequent attacks against oil facilities and kidnapping of expatriates working for international oil companies. It is too early to say with certainty that this marks an end to the conflict. Most observers are skeptical that the rebels will lay down their arms. This is especially hard to believe, since the sabotage of crude pipelines and ransoms paid for kidnapped workers, have been very lucrative for the rebels.

It is true that government forces have recently become less tolerant of the rebels and seem ready to launch an all out attack to eliminate their ability to continue to undermine Nigeria's vital petroleum sector. An attack in July on a fuel depot close to the financial district in Lagos showed how the festering conflict in the Niger Delta has become increasingly dangerous for the country with the passage of time.

Nigeria is the 5th largest source of crude for the US and the country also boasts giant gas reserves. Major energy companies are anxiously watching the political situation for signs of if or when stability will/can be achieved. They are also mindful of the government's inability to address the chronic under funding in the oil sector, which threatens to plunge production into terminal decline.

Ten years after its transition from military to civilian rule, progress towards reversing decades of declining living standards and restoring the social contract between the government and the people is agonizingly slow. Over the past two years since the sitting President took office, frustration has intensified.

Faith in the government's ability to deliver on reforms of energy, power and infrastructure, is evaporating. General elections are to be held in 2011 and the risk that the campaign could turn into mayhem, as occurred in 2007, is a real possibility.

It is true that Nigeria has survived repeated bouts of political and economic crisis since independence in 1960. This is a tribute to the resilience of its people. Yet, today there is a sense that the country is teetering between two very different futures. The optimistic view is that a burst of private sector led growth, unleashed by government action to solve the chronic power crisis, diversifies the economy and spurs a rapid re-emergence of a middle class. This envisions the size of the Nigerian market would continue to draw investors and inspire entrepreneurs.

The second possibility is bleak, with visions of communal violence, endemic corruption and lawlessness. The government faces a tough job if Nigeria is to achieve the former and escape the second scenario.

Venezuela

The government acknowledged that the spread between the official exchange rate and the unofficial curb rate have become too wide. The authorities indicated that it will seek to narrow that gap but gave no details on how that would be accomplished. The official rate for the Bolivar [at which dollars are offered by Cadivi] is 2.1:US\$1, while the curb rate is at 7:US\$1 with forecasts that it will hit 8:US\$1 by year-end.

The Central Bank has slashed the rate it pays banks on short-term loans by 5%, making it sharply negative in real terms. Banks are already required to devote 40% of their lending to "productive sectors" such as agriculture, tourism, and manufacturing. Only 30% of their total holdings can be kept in foreign exchange, so having the banks invest in government bonds is not a big problem for the Chavez government.

The possibility of a formal devaluation of the official exchange rate cannot be ruled out, since Venezuela depends for 93% of its exports and half of fiscal revenues on oil. While petroleum prices have increased this year, they are still down by half from record levels of July 2008. Devaluing the official Bolivar would increase the government's local currency take from oil exports and ease fiscal pressures. Devaluation would, however, add fuel to the fires of inflation, which accelerated to the 29% range, the highest rate in the Americas. To avoid devaluation, the regime may prefer to continue the back-door devaluation it has been engineering by forcing ever more exchange transactions from Cadivi, which deals at the official rate, to the parallel market.

A wilting economy and lack of money to spend on sweeping welfare programs promised by President Chavez have started to sap his popularity. He reportedly has set aside \$12 billion from Central Bank reserves and traveled to China, Japan, and Brazil and Russia in search of loans. He recently promised to launch a stimulus package. A possible loan from

Russia in the \$4 billion range is said to be also under discussion, in support of a planned joint venture between Gasprom Latin America and PdVSA's service company. Venezuela has ambitions to buy Russian military equipment (including tanks) presumably to counter the threat of US bases in Colombia.

The future of one of the world's biggest oil auctions is in jeopardy as the government and oil companies remain at loggerheads over terms to develop a key oil field. Repeated delays in bidding for rights to exploit the Orinoco Belt - which was postponed for a third time at the end of last month-reflect investor concerns about political risk, onerous financing costs and the profitability of the projects. Uncertain oil prices and a stuttering global economy only add to the problem.

Chinese, Russian, Indian and Brazilian state oil companies are competing along side oil majors such as Shell, BP, Chevron, Total ENI and Statoil for access to the Orinoco's Carabobo block, which could require collective investment of between \$30 billion and \$50 billion in three projects together producing potentially up to 41.2 million barrels per day. At the top of the list are fears about the unstable political climate in Venezuela and the unpredictability of President Chavez. The expropriation of assets of more than 70 oil services companies this year alone gives meaning to the discomfort among prospective investors.

Worries about the sanctity of contracts have been deepened by the fact that the tax rates for oil companies have been increased four times since 2004, while PDVSA, the Venezuelan state oil company has been negligent in paying dividends to partners in joint ventures. Such concerns explain why companies are insisting on having the right to settle contract disputes in international courts.

PDVSA is reluctant to comply, arguing that this would compromise national sovereignty - even though international arbitration clauses were included in contracts signed with Russia, a close ally of Venezuela. Another obstacle relates to the stiff financial terms, particularly with tough conditions in international capital; markets. In spite of companies being allowed 40% share in each of the projects up for auction, with PDVSA maintaining 60%, they are being asked to provide 100% of the financing. The fiscal terms are equally hard for companies to swallow, with 33% royalty rates and a newly introduced windfall tax generating deep misgivings.

China

China has shown the clearest rebound so far from the global slump. Initial readings suggest that China rebounded with vigor in the second quarter. Official GDP growth for the first half of the year was recorded at 7%. There is hardly a doubt that China can achieve its projected 8% GDP growth for 2009. However, despite its quick and bold response to the crisis, there are discrepancies over the reliability of the data, which seem to be producing a V-shaped recovery. The data from the provinces when compared with that released by the central government suggests some level of exaggeration in the statistics. There is evidence that other problems loom as well.

Of the 6.1 million college graduates this year, authorities say so far some 50% have found jobs. Another 1.2 million of last year's graduates have not yet secured employment. Of the 23 million workers who were laid off last year (most of whom, returned to the countryside), it is uncertain how many have been able to find new jobs. Also, salaries in the private sector have fallen such that recent college graduates are inclined to accept public sector jobs instead. Others have been forced to accept lower level positions in the service sector.

While official figures indicate growth in consumption and income, private analysts believe the numbers are unreliable as they are heavily weighted toward state-sector salaries and government procurement. As far as private consumption and incomes, these are believed to be growing only a bit, if at all. Then there are the effects of the increased levels of investments made possible by the huge \$585 billion stimulus package approved in 2008 as a response to the global crisis. While the stimulus allowed production to continue, it threatens to worsen an already severe case of overcapacity. Also, the explosion in new bank lending during in the first half of this year amounted to triple the amount lent in the same period a year earlier. The loans represented 45% of GDP for half-year. This lending boom by China's state-controlled banks on the orders of the central government is suspected to have used been partly for speculative purposes. Instead of spurring economic activity as was intended, money was borrowed and then invested in the stock market and for used for real estate investments. The authorities are voicing concerns over the possibility of the creation of an asset bubble, an explosion in inflation, and they worry that the large amount of loans will result in a significant spike in bad debts at the banks. The banks have been told to end the lending spree.