

EFIC World Risk Developments – January 2008

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News in brief

Developments since mid-December 2007 ...

- The **Philippine** and **Indonesian** governments both tapped the international bond market – Manila for US\$500m at a spread of 220bp and Jakarta for US\$2b at a spread of 298-329bp.
- The **US** Federal Reserve cut its benchmark interest rate by 75bp on 22 January, and another 50bp on 30 January. A US\$150b White House fiscal stimulus package is now being debated in the Senate after the House of Representatives passed it.
- The government of the **DR Congo** and various militia signed a peace deal in Goma, the capital of North Kivu province. The Congo is currently experiencing a resource boom thanks to brisk international demand for minerals – it has the second largest reserves worldwide of copper and cobalt (10% of worldwide reserves) and also vast potential in zinc, cadmium, diamonds, gold, tin, tungsten and manganese. Yet conflict, especially in the eastern Congo, had resulted in 5.4 million deaths between 1998 and April 2007, according to the International Rescue Committee.
- World sharemarkets fell sharply on 21 January, partly on news of a downgrade by ratings agency Fitch of Ambac Assurance, the world's No 2 **bond insurer**, from its top AAA rating to AA. Fitch expressed concern that Ambac's insurance of collateralised debt obligations based on US sub-prime mortgages could erode its capital base. The downgrade has in turn forced a wave of downgrades of the bonds Ambac has insured. This could force institutions authorised to hold only high-grade credit to sell their downgraded

securities, driving asset prices down and generating new billion-dollar losses across the financial system.

- Ratings agency Standard and Poor's downgraded **Citigroup** to AA- with a negative outlook because of large sub-prime-related writedowns.
- **Zambia** announced significant revisions to its mining taxation policy, to take effect in the first quarter of 2008, which will eliminate the special 'development agreements' with mining companies struck when copper prices were at record lows. The new regime will see introduction of a windfall tax and a variable profit tax and comes on top of a previously announced increase in mining royalties from 0.6% to 3%, a lift in company tax from 25% to 30%, and re-introduction of a 15% withholding tax on dividends.
- The consortium operating **Kazakhstan's** Kashagan field settled a dispute with the government over the field's development. Kashagan is the biggest oil find of the past 30 years and in full production should produce 1½ million barrels a day. The consortium's foreign partners, Eni, ExxonMobil, Shell and Total, are to dilute their stakes to allow an increase in equity for Kazakhstan's oil and gas company Kazmunaygaz from 8.33% to 16.81%. The deal represents a revision of the production-sharing agreement in the state's favour. The government has followed Moscow's example with the Sakhalin-2 project in forcing foreign partners to cede it more of the field's value.
- The opposition Kuomintang (KMT) won **Taiwan's** legislative elections on 12 January, trouncing the ruling Democratic Progressive Party. Its decisive win puts the KMT in a strong position to win the March presidential election and to press for relaxation of restrictions on economic relations with China.
- A group of Kuwaiti firms announced that they planned to invest more than US\$10b in **Philippine** airports, ports, railways, power stations and telecoms, while Qatar's sovereign wealth fund said it planned to invest US\$850m in **Indonesia**. Gulf Arab states and companies with ample petrodollars are looking to invest more in Asia, whose economies are outgrowing those of the traditional investment destinations, the US and Europe.
- **Indonesia's** new mining laws struck unexpected obstacles in parliament meaning they are unlikely to pass till the first quarter of 2008. They have been criticised by the mining industry for, among other things, requiring ore to be processed locally and introducing a licensing system that excludes the option of international arbitration.
- The **Malaysian** government announced a freeze on recruitment of workers from India and Bangladesh. The move comes amidst rising social tension between ethnic Malays and Indians that have seen attacks on Hindu temples and a mass demonstration by the Hindu rights group Hindraf in November.
- Russia's Gazprom said it was in talks with the **Nigerian** government about investing US\$1b-2½b in LNG production and the capture of gas associated with oil production – currently flared. It reportedly has big plans to invest in the Gulf of Guinea and to compete with Western energy companies for concessions.
- The **Argentine** government looks set to impose export taxes on previously exempt mining companies, including subsidiaries of Xstrata and Rio Tinto. The export taxes were introduced on other companies in 2002 but many mining operators were expected to continue to benefit from a tax exemption and stability agreement put into mining laws enacted in the 1990s.
- Militants killed 18 people in multiple attacks on Port Harcourt, the capital of **Nigeria's** Rivers State in the Niger Delta, following a breakdown of talks with the government and military bombing raids on suspected militant hideouts.

- **Brazilian** state petroleum company Petrobras said in December that it had reached a new daily output record of just over 2 million barrels. It brought six new platforms online in 2007, raising output by 590,000 barrels a day.

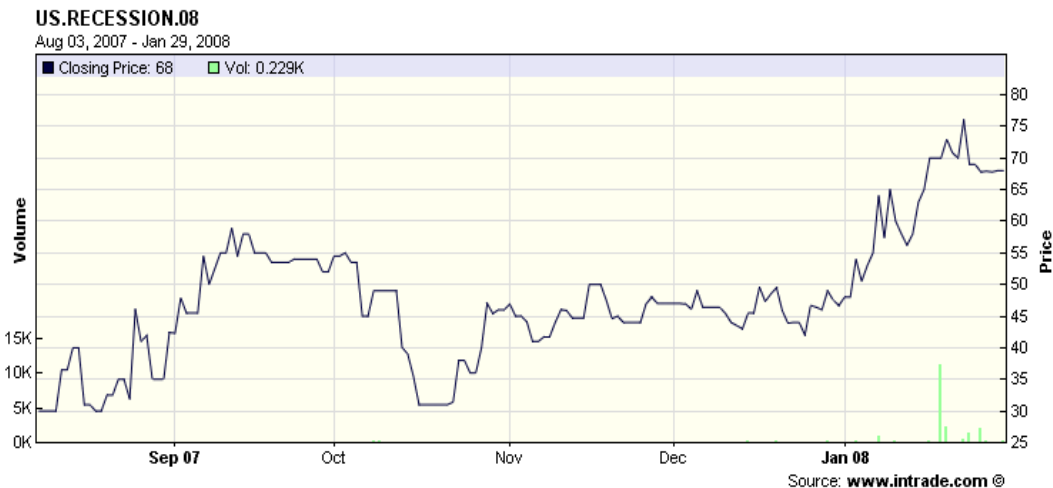
International – Heated debate on economic outlook emerges

A heated debate has emerged on the likely extent of the current worldwide credit squeeze and its knock-on effects to the US and world economies. Key areas of disagreement are whether the credit 'squeeze' will morph into a 'crunch' and whether emerging economies can 'decouple' from any US recession.

A marked deterioration in the US economic datastream in December, coupled with oil price rises and signs that financial institutions would declare further large losses, have given the debate added impetus. There are a host of contractionary forces in play, but also some expansionary ones, and people are arguing about which will predominate.

Data. Up till November, the US data were surprisingly strong. But in December they took a sharp turn for the worse, with private employment, retail sales and manufacturing output all showing falls. The economists who read these tea leaves are now having a debate on whether the December weakness is simply temporary payback for earlier strength after which growth will resume – or whether it marks the onset of recession.

In any event, the markets are now pricing in almost a 70% probability that the US will go into recession in 2008. For instance, one can buy a contract for close to 70c in the Intrade prediction market that pays out \$1 if recession occurs. Back in August, the price was 30c (see chart).



Money markets. In world money markets, coordinated injections of liquidity by central banks in December served to reduce funding pressures on banks. As a result, spreads between three-month interbank rates and overnight swap rates have fallen around 50bp from their 100bp+ peak. Still, they remain above the 0-20 bp range they were in during the previous boom.

Credit markets. In world credit markets, the strains have not been as great, though risk premiums have moved up, and issuance down.

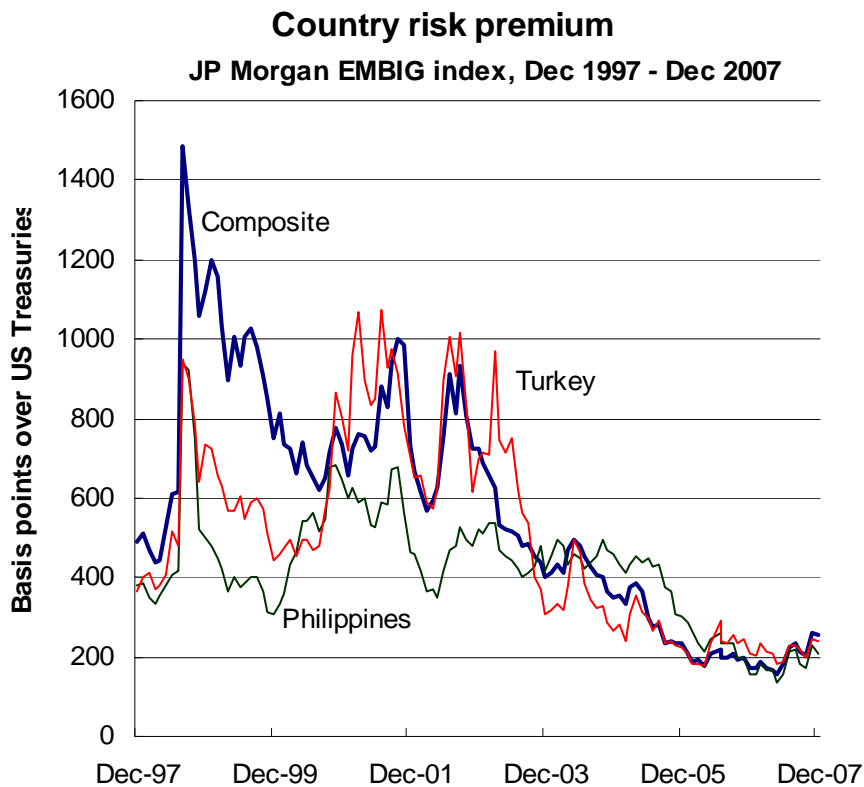
Speculative-grade bonds in advanced economies have been hardest hit. According to ratings agency Standard & Poor's, speculative-grade corporate bond issuance fell 49% in the US in the second half of 2007 compared with the second half of 2006,

while investment-grade issuance fell 12%. In Europe the trends were similar. The abrupt widening of credit spreads last northern summer particularly hit new issuance of speculative-grade bonds, which dried up completely for a few months. But borrowers are adjusting to the new lending conditions relatively quickly, according to Standard & Poor's.

Project finance. In the project finance market, numerous major deals were put on hold from mid-2007, but are expected to return to market in 2008, with an average 20 bp increase in debt margins, according to *Project Finance* magazine.

Emerging markets. Emerging market borrowers have been least affected. The Institute of International Finance estimates that net capital flows to emerging markets were US\$681b in 2007, some US\$60b more than its October forecast, reflecting sustained strong flows even after the onset of the market turmoil.

Spreads on emerging markets sovereign bonds have widened about 80bp, but still remain near historical lows (see chart).



Writedowns. So far the writedowns announced by major financial institutions amount to US\$91b (on collateralised debt obligations, sub-prime residential mortgage-backed securities and leveraged loans). However, capital injections of about US\$49b mainly by Gulf and Asian sovereign wealth funds have helped to keep capital levels more or less adequate – though ratings agencies are keeping the institutions concerned under close scrutiny.

Contractionary forces. Pessimists predicting a US recession that spills over into a worldwide economic slowdown, such as the commentator Nouriel Roubini (www.RGEMonitor.com), make these points.

- **The US housing bust will get worse.** New home sales are plummeting faster than housing starts, meaning that the glut of new and existing dwellings is rising. According to some estimates, housing starts need to fall another

25%, and home prices to fall 20-30% in total, before supply and demand come back into balance. So far prices have fallen only 6% from their peak.

- **As the housing bust deepens, sub-prime-related losses among financial institutions will multiply.** Some households will default because, following interest rate resets and job losses, they can't pay. Many millions of others will see their home equity vanish as prices fall, and a fraction will decide to hand back the keys to the bank. Either way, the defaults will force financial institutions into further write-downs of mortgage-related securities.
- **Worse, the defaults and corresponding financial losses are spreading to other areas of reckless lending.** These include prime mortgages, commercial real estate, car loans, credit cards, leveraged loans, corporate bonds, and related credit default swaps.
- **The ultimate losses could be many times what's been declared already, and are likely to impose a nasty credit crunch.** According to one estimate, the US\$91b of mortgage-related losses already declared could expand to US\$400b, and total financial losses to US\$1 trillion. And since lending is geared to capital, such capital destruction can result in a disproportionate credit contraction. Last month's *World Risk Developments* cited a Goldman Sachs estimate that US\$200b of losses could lead to a credit contraction of US\$2 trillion. Bank recapitalisation won't be large enough or rapid enough to offset this contraction, argue the pessimists.
- **So the stage is set for a downward spiral of foreclosures, losses, credit contraction, and retrenchment by consumers and businesses.** With the US economy already stalling, this means recession is inevitable.
- **The authorities will carry out fiscal and monetary expansion, but this will only moderate the recession, not head it off.** One obstacle will be a lack of capital adequacy among many financial institutions. Giving emergency liquidity to decapitalised institutions isn't going to help them lend more. They need to do the hard work of recapitalising first.
- **Recent oil price rises and a sharp slowdown in the world's No 2 economy, Japan, are additional setbacks to simultaneously hit the world economy.** In other words, the world has more to cope with than just the sub-prime mess.
- **'Decoupling' by emerging markets from a contracting US economy is wishful thinking.** Emerging markets are too dependent on exporting to the almighty US economy - still a quarter of world GDP – to escape without a major hit. And being so wedded to exports, they are incapable of stimulating domestic demand to offset the coming export slump.

Offsets. More optimistic commentators, such as the World Bank in its recent *Global Economic Prospects* (econ.worldbank.org) and the Australian economics professor and Reserve Bank board member Warwick McKibbin, either tend to downplay the scale of US financial losses or stress a range of factors that will moderate the credit contraction and resultant economic downturn. They foresee a 'soft landing' for the US economy and only moderate global slowdown – returning previously above-trend growth to trend. They note that

- **The financial losses appear to be manageable.** They have prompted a credit 'squeeze' rather than 'crunch'. Risk premiums have risen, but remain relatively low by historical standards, and capital flows remain plentiful.
- **Decoupling is likely.** In contrast with previous business cycle downturns, emerging markets this time have for the most part strong fundamentals, including external current account surpluses, undervalued exchange rates, and often-mammoth foreign-exchange reserves. This gives them scope to

stimulate their economies without suffering balance of payments crises. Moreover, it is mistaken to think all have muscle-bound export sectors, but puny domestic economies. In fact, an infrastructure and investment boom is underway in many significant sectors and economies, including the worldwide resource sector, the Gulf economies and East Asia. This gives significant domestic momentum to many economies. The third fact to remember is that emerging economies have recently become a world growth locomotive in their own right – China alone contributed 30% of world GDP growth in 2006. This gives them the ability to cushion the impact of a slowing US.

Downside risks. Even the optimists acknowledge, however, that there is a need to be vigilant. While the most likely outcome is a moderate global slowdown, more things could go wrong with their base case than right.

Vulnerable economies. Moreover, optimists and pessimists agree that these aren't good times for countries with large fiscal and current account deficits (CADs) and overvalued, especially pegged, exchange rates. In the current climate of risk aversion, such countries are prone to capital outflow that can trigger currency runs and balance of payments crises.

- **Kazakhstan.** This petroleum-rich country got a foretaste of the risks in store when it experienced a sudden stop to capital inflow last year. This brought its credit boom to an end, and caused GDP growth to slow in the final quarter to around 5% pa from 10% pa earlier in the year. The authorities, who peg their currency to the US dollar, are currently financing their CAD, equivalent to 8% of GDP, by drawing down foreign exchange reserves. Because the country exports oil, gas, minerals and grains into sellers' markets, and has built up a sizeable oil stabilisation fund, it probably won't succumb to a full-blown crisis. But this does remain a risk and illustrates how quickly economies can come unstuck.
- **Central & Eastern Europe (CEE).** Several countries in the vulnerable category are in the CEE region. Hungary, Romania and Poland are prime examples. The Baltic states also have large current account deficits and high inflation, though their government budgets are more or less balanced.
- **Turkey.** Another country with a large current account deficit and overvalued exchange rate, one moreover that shows high political risk, is Turkey. The worrying numbers are – a CAD equivalent to 7½% of GDP in 2007, an external financing need (CAD + amortisation of existing debt) estimated by the IMF at US\$106b in 2008, a short net foreign exchange position of more than US\$50b held by non-bank companies, net FDI inflows of only around US\$20b pa, portfolio capital *outflows* of around US\$6b over July-November 2007, and a real exchange rate more than 50% stronger than its 15-year average.

In addition, the politics are unstable. Tensions remain between the moderately Islamist government and president on the one hand and the secularist establishment, including the military high command, on the other. The secularists suspect the government of wanting to push a 'hidden Islamist agenda' that would eat at the foundations of the secular state established by Kemal Ataturk. Conflict is looming over plans by the government to allow women to wear headscarves in universities. Another military coup is unlikely. But the secularists could organise mass street protests, as they have done in the past, and apply to the courts to ban the ruling party, as they have done to its predecessors.

The combination of large external financing requirements, very strong exchange rate, political instability and global risk aversion exposes Turkey to considerable external debt rollover risk. In the event of a withdrawal of

capital, interest rates could move up and the lira down sharply, and the economy could slow rapidly. How big might the adjustments be? A previous increase in global risk aversion in May/June 2006 coinciding with domestic setbacks (delays in meeting IMF conditions and appointing a central bank governor) prompted the central bank to hike the official interest rate by 600bp. Such an adjustment could happen again. It could push the economy into recession from its current 5½% pa growth rate.

Pakistan – Bhutto assassination deepens existing divisions

Tension is high, following the assassination of former Prime Minister Benazir Bhutto on 27 December.

In Bhutto's home province of Sindh, hundreds of bank branches, railway bridges, stations and trains have been destroyed. A suicide bombing outside the Lahore High Court killed at least 22 people on 10 January and at least 10 people were killed on 17 January when a Shia mosque was attacked in Peshawar. The assassination has compounded deep existing political, ethnic and sectarian divisions within Pakistan. President Pervez Musharraf has committed to hold rescheduled elections on 18 February, but further postponement or unrest remain possible.

Sri Lanka – Ceasefire burial dead *and* buried

The government's decision on 3 January to formally withdraw from a 2002 ceasefire agreement with the Liberation Tigers of Tamil Eelam (LTTE) will remove the one remaining restraint on conflict.

Repeated violations of the deal by both sides had already left it in tatters. But the formal withdrawal shows the determination of the government to defeat by force the rebels whom it claims have violated the peace deal thousands of times. For their part, the LTTE have made conflicting statements – expressing 'shock and disappointment' with the government's decision, but also saying they are ready for 'full-scale war'. The ceasefire is due to formally end on 16 January, by when a Norwegian-led monitoring team has been asked to leave. Though neither side has shown much respect for the Norwegian-brokered ceasefire deal, the conflict is now likely to escalate even further.

Kenya – Political crisis has wide economic repercussions

Kenya looks to be heading for a prolonged period of political instability as President Mwai Kibaki tries to strengthen his grip on power in the face of fresh outbreaks of violence and international pressure. This will do considerable economic damage and may damp foreign investor interest in Kenya and East Africa more broadly.

Political standoff. More than 700 people had been killed and around 200,000 displaced as a result of the violence sparked by Kenya's contested presidential election. The post-election violence seems to have morphed in recent days into inter-ethnic violence that will take a long time to resolve. Moreover, there is little sign that President Kibaki and his opposition rival, Raila Odinga, are settling their differences. Kibaki is reportedly sticking to the line that he is the 'duly elected' president to the annoyance of Odinga.

New international mediation efforts led by former UN Secretary-General Kofi Annan, have raised hopes of a political reconciliation, but the gap between the two sides remains wide. Although the US and EU have made noises about suspending aid unless the standoff is resolved, this is probably an empty threat: Kenya is one of the

least aid-dependent countries in Africa and, more importantly, is a key ally in counter-terrorism operations in East Africa.

The scene is set for a long period of political uncertainty and further outbreaks of violence between supporters of Kibaki and Odinga. This will compound the economic damage inflicted during the height of the post-election violence in late December and early January.

Economic fallout. According to the Kenyan Finance Minister, the violence and disruptions could cost his economy, East Africa's largest, around US\$1b. The tourism industry, Kenya's largest export earner, has been hit as many countries tighten their official travel warnings and holiday makers cancel bookings. Tea and coffee auctions have been postponed. The stockmarket has fallen sharply. In offshore trading the exchange rate has fallen to an eight-month low.

Investment. Tourism in particular has been weakened by the violence and political uncertainty. Tourist arrivals are unlikely to bounce back quickly; the industry had only just recovered from the effects of land clashes in Mombasa in 1997, the 1998 US Embassy bombings, and a 2002 bombing at a coastal resort.

Foreign investors more broadly are likely to be wary of committing funds now that Kenya's reputation as a haven of (relative) stability in East Africa has been lost.

- Government plans to use Kenya's B+ sovereign credit rating from Standard & Poor's to borrow in international capital markets will almost certainly now be postponed.
- A planned IPO of government-owned Safaricom, East Africa's largest mobile phone company, will probably also be delayed.
- Foreign oil companies could be deterred from further exploration and development of East Africa's oil and gas potential. Australia's Woodside has offshore exploration acreage in Kenya.

Regional knock-on effects. The clutch of central and east African countries that depend on Kenya's Indian Ocean port at Mombasa are also being knocked. Road blocks and other disruptions have slowed transport of fuel and food within Kenya, and to Uganda, Rwanda and Burundi, leading to shortages and price hikes.

The contested election has ignited latent, but deep-seated tribal and ethnic rivalries. Whatever political resolution finally occurs, these rivalries will remain a source of instability.

Philippines – New People's Army remains threat to miners

A New Year's Day attack by the New People's Army (NPA) on Xstrata's Tampakan copper-gold project shows that the rebel group is still capable of causing significant disruption to mining operations.

Mine attack. The Tampakan project in the southern Philippine island of Mindanao, owned by Xstrata and ASX-listed Indophil Resources, is potentially one of the largest undeveloped copper-gold deposits in South-East Asia. Around 60-70 NPA rebels attacked the project's base camp on New Year's Day, setting fire to two buildings and firing grenade launchers and automatic weapons. No injuries were reported.

Communist insurgency. The NPA is a communist rebel group that has been waging an insurgency since the late 1960s, mainly in the countryside, to establish a Maoist state. It was thought to be a largely spent force, particularly after a US and

EU blacklisting of the organisation as a terrorist group thwarted its fund-raising. Current estimates put the number of members at around 5,000, well down from an estimated peak membership of 25,000 in the mid-1980s. The drying-up of overseas financing has pushed the NPA to target banks and to extort 'revolutionary taxes' from mining and logging companies, especially where they can muster local support.

Risk management. The NPA's power and influence has dwindled over the years, though it is still able to launch frequent attacks on strategic economic targets, such as mine sites and telecom infrastructure. Many of the prime undeveloped mineral deposits in the Philippines are in areas where the NPA or other rebel groups are active. Building local support for mining operations is an important way to mitigate the risk of extortion or attack.

Thailand – Political faultlines remain

The election of People Power Party (PPP) leader Samak Sundaravej as prime minister marks the country's latest step towards restoration of civilian government. It also signals the return to power of allies of former prime minister Thaksin Shinawatra. These developments will do little to heal a deep political fracture between rural and urban voters, raising the spectre of a return to the unstable coalition governments of the 1990s.

Polarised politics. The interim government, that has been ruling since last September's coup, and other critics charged the PPP with violating electoral law by acting as a proxy for the banned Thai Rak Thai, the party of the former prime minister (a claim rejected by the Supreme Court on 18 January). Parliament reconvened on 21 January – the first time since the elections – and subsequently elected PPP leader, Samak Sundaravej, as premier. A six-party coalition government is expected to be formed once ministerial portfolios are allocated. But this will do little to bridge the rural-urban divide, and anti-Thaksin forces, including within the Thai armed forces, are likely to interfere in politics, particularly if they judge that the PPP is intent on seeking retribution for the coup that led to Thaksin's ouster. Moreover, the size of the coalition will make it unwieldy. The stage is set for a return to the unstable coalitions of the 1990s, when precarious political alliances frequently formed and collapsed.

Investor uncertainty. The prospect of further political instability is bad news for the economy. The political uncertainty sparked by the coup and the military-backed government's decision to introduce capital controls have damaged the investment and business climate, as well as stymied much-needed structural and regulatory reforms. International investors are increasingly overlooking Thailand in favour of countries like Vietnam; some Japanese firms are already reportedly switching production to Vietnam.

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