Major Country Risk Developments
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By Byron Shoulton

Global Overview

The U.S. Federal Reserve cut interest rates by a quarter-percentage point at the end of July- the first reduction since 2008- in an attempt to cushion the economy from a global slowdown and continuing trade tensions. Stock markets sold off and the U.S. dollar strengthened. The Fed did not rule out additional rate cuts but promised to monitor for signs of economic weakness in the months ahead. The U.S. economy added 164,000 non-farm jobs in July, providing further evidence that economic activity continues to generate new hiring at a steady pace, despite a global slowdown. Job growth in the previous month was revised down to 191,000. The unemployment rate remained at 3.7% close to a 50-year low.

The U.S. manufacturing sector contracted for the last two consecutive quarters, but brisk consumer spending has acted as a counter-weight buoying economic momentum elsewhere in the economy. Manufacturing production was down 1.9% and 2.2%, respectively driven by weaker auto and auto parts production, as that sector faces a slowdown. Automakers Ford and Nissan are cutting jobs and earnings forecasts.

The ongoing trade tensions have resulted in weaker demand from China for U.S. goods, and it has disrupted supply chains and inventory management for U.S. manufacturers. The latest round of bilateral trade talks between the U.S. and China ended without any compromises prompting President Trump to announce that effective September 1st, the U.S. will impose a 10% tariff on $300 billion worth of Chinese exports that so far have been exempt from tariffs. China promised to retaliate. Soon thereafter, the Chinese currency the RMB weakened to RMB7:US$1 for the first time in eleven years; a clear signal that both sides remain far apart and may no longer be looking toward an early resolution of the trade war.

Allowing the RMB to break seven against the dollar is viewed as a carefully calculated gamble by China that it can use the currency to ameliorate the worst effects of the trade war with the U.S. (hopefully without triggering capital flight). President Trump accused the Chinese of currency manipulation. The U.S. also accused the Chinese of reneging on promises to start buying large quantities of U.S. agricultural goods again. The Chinese say they did buy some goods, but say other deals were not possible due to uncompetitive pricing. Furthermore, China now appears unwilling to consider any further concessions to the U.S. until and unless tariffs are removed. After the Chinese currency tumbled to its weakest level in more than a decade, the Chinese government directed state-owned companies to suspend imports of U.S. agricultural products.

Allowing the RMB to weaken is not without risk for China. A mid-2015 devaluation spurred capital outflows and destabilized global markets, though tighter capital controls this time around should help prevent another exodus of funds.

Factory orders and purchasing managers' indices for the eurozone, the UK, Japan and China all show contraction in manufacturing. That puts pressure on these currencies [versus the dollar], making U.S. exports more expensive and hence less competitive. Some see parallels with the manufacturing recession of 2015-16 and worry that this time it will lead to an overall economic contraction. In both cases, weakness was/is driven by economic slowdown in China and a strong U.S. dollar. In 2015 as now, the dollar appreciated in part because of stronger perceived economic fundamentals in the U.S. than abroad. The

Fed's decision to pause rate increases as financial conditions tightened sharply in 2015, helped weaken the dollar and arguably kept the slowdown in manufacturing from dragging the overall economy into recession. Today, however, financial conditions are already easy with low interest rates. Meanwhile, the Fed's rapid shift in tone from rate rises to rate cuts since the beginning of this year has done little to weaken the dollar.

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The Chinese economy slowed to 6.2% annual growth in the second quarter, down from 6.4% during the first quarter. Combined with increasing headwinds from U.S. tariffs and weaker global growth, and without a U.S.-China trade agreement, the expectation is for continued slowdown in Chinese economic growth over the coming year. The consensus is that Beijing may need to introduce further stimulus measures to meet its full-year GDP growth target of between 6% and 6.5%. New investment by the private sector, especially in manufacturing, will likely be held back by the escalating trade tensions with the U.S.

In Southeast Asia manufacturing conditions also worsened for a second consecutive month with factory output falling for the first time in two years, and manufacturing activity contracted across Japan, South Korea and Taiwan. In a sign that manufacturers' woes are likely to persist into the second half of this year, South Korean exports declined for the eighth consecutive month. The latest figures show that new export orders for South Korean manufacturers [Asia's fourth-biggest economy] fell by their fastest rate in almost six years. The south Korean won, which fell against the dollar, remains particularly exposed to trade war risks in addition to weak external and domestic growth.

The manufacturing sector in Indonesia, Asean's largest economy, slipped into decline for the first time in six months, with employment numbers reduced at their fastest pace in 19 months. Conditions in Malaysia and Singapore continued to deteriorate, although the pace of the latter's decline moderated in June-July.

A manufacturing slowdown need not necessarily result in an economic recession, unless it spreads to other sectors and across several countries simultaneously. Fifty years ago, U.S. manufacturing represented almost 25% of total GDP. Today it accounts for only 11% of total GDP and 8% of employment. The U.S. has become a services-based economy, and the data for services have remained buoyant in the U.S. and abroad. Furthermore, the nature and direction of investment has changed drastically over the past two decades. In 1998, nearly 50% of non-residential fixed investment in the U.S. went into new structures and industrial equipment to boost manufacturing capacity, while 30% went into information processing equipment and intellectual property. In the first half of 2019 the percentages were reversed, with roughly 30% of new investment going into structures and equipment while 50% went into technology. Optimists will highlight the potential for these tech investments to result in higher productivity growth and potential economic growth. However, the impact will be felt only over the medium term, once workers have learned to use the new technologies to improve their productivity. In the short-term, this shift from tangible to intangible investment tends to be bad for workers: i.e. factories create more jobs than the likes of tech applications like WhatsApp.

There are other important differences in economic trends from four years ago. In 2015-16, consumer spending rose an average 2.8% annually. In the most recent quarter consumer spending grew by a brisk 4.3%. Back then, a collapse in oil prices crimped investment in energy; today, oil prices are much higher than in 2015.

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Hong Kong

For more than two months ongoing street protests and anti-government demonstrations by Hong Kong residents against the influence of the Chinese central government on Hong Kong's affairs, has tested the limits of the "one state two systems" policy which governs the relationship between the two. The growing aggressiveness of the demonstrations and the level of disruptions they have caused, is testing the patience of the Chinese authorities. While mainland China's government has indicated that order must be enforced in the Chinese territory, Chinese troops have not yet been introduced into the standoff. However, this most direct challenge so far to the rulers in Beijing is unlikely to pass without a response.

So far, remarkable restraint has been in evidence by Hong Kong security forces, except for the use of tear gas to break-up mass groupings. Chinese security forces, in full riot gear have been observed in training close to Hong Kong. Deploying the Chinese army to restore order would be unprecedented and would only add to the state of confusion and distrust that's already present in Hong Kong. The demonstrations have hurt business prospects while encouraging capital flight from Hong Kong. China's leadership is blaming the U.S. for being the hidden hand behind these demonstrations. The situation is especially worrisome as they have grown in intensity and include organized workers groups and civil servants who appear increasingly focused on disrupting day-to-day business flows, travel and communications within Hong Kong.

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The industrial action and demonstrations started over two months ago with opposition to an extradition bill that would allow criminal suspects in Hong Kong to be tried in China. The protesters' demands have since gone beyond withdrawing the bill to include calls for a more democratic system of government in the territory. In particular, Hong Kong residents are demanding that they be allowed to vote to elect the territory's chief executive. Currently, the chief executive is selected by a Beijing handpicked supervisory board and approved by Beijing.

Hong Kong's stock market has fallen as a result, and the latest purchasing managers' survey shows that private sector business activity has suffered the sharpest contraction since the aftermath of the global financial crisis. Flight cancellations increased (over 200 flights canceled in one day) following clashes between police and protestors after four straight days of demonstrations against the government. There were widespread delays and service suspensions on Hong Kong's metro railway network. The aim is apparently to force government concessions by crippling essential infrastructure and disrupting basic services.

Colombia

The 2019 budget focuses on economic reactivation measures and includes incentives for investment in minerals and hydrocarbon exploration, and infrastructure projects. Tax breaks for investment in innovation are available. GDP growth was flat in the first quarter of 2019, following growth of 2.6% in 2018. The expectation is that Colombia's upturn will endure over next year as household demand is bolstered by higher real wages (amid tamer inflation), the expanding labor market (driven by the influx of Venezuelan migrants) and stable average commodity prices. During his first year in office, Colombian president Ivan Duque has developed a tense and unproductive relationship with congress. Measured in terms of approved legislation and according to his critics, Mr.

Duque's presidency has been less productive than any of the four preceding presidential terms. In order to have a smoother relationship with congress and pave the way for a more successful second year, the president is being urged to consider making changes to his cabinet.

One of the initial promises made by Mr. Duque was to prioritize technical over political considerations in selecting cabinet members. A year down the road, it has become evident that certain members of his cabinet are not technocrats and were unprepared for the tasks they were assigned. Various missteps by cabinet members have taken a toll on the political capital of the Duque administration.

Mr. Duque's weak legislative support results in large part from his promise to crack down on pork-barrel politics – the use of public spending and the awarding of positions in government in exchange for voting in line with the executive, which has long been a source of corruption in Colombia. Little has changed on this front so far. Congress has successfully approved a few major initiatives, such as the four-year national development plan, a reform of the telecoms and IT law and tax reform. However, many government proposals have stalled or were rejected by the legislature. Congress is not alone in its aversion to the current make-up of the cabinet. A recent survey suggests that 68% of the Colombian public disapproves of the cabinet. The poll also confirms growing concern over the state of the economy and pessimism over the government's faltering efforts to pass anti-corruption legislation. With a less collaborative congress and municipal elections approaching in October, the onus is on the government to bolster support for Mr. Duque with the public.

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Growth is expected to be constrained during 2020, owing to softer oil prices and a projected slowdown in the U.S. – Colombia's largest trading and investment partner. Orthodox, market friendly policies have been in place since 2000 and continue to underpin stability for investors in Colombia. Policymaking will continue to focus on boosting economic growth, fiscal discipline, inflation control and improvements to the business climate. The government has also targeted social and infrastructure spending to reduce poverty, and boost competitiveness and trade. Open policies for business are expected to remain in the years ahead and a generally open foreign trade and foreign exchange regime will provide strong competitive advantages for Colombian businesses. Incentives to attract investment in oil & gas, mining, road construction, power, agri-business, tourism, technology start-ups and telecommunications remain in place. Bilateral investment treaties and free-trade agreements have been effectively enforced in this country. Risks to the forecast stem from Colombia's dependence on fiscal and external revenue from a few commodities, notably oil and coal, which leaves the country exposed to swings in international markets.

The public debt/GDP ratio is expected to decline in 2020, bolstering debt sustainability. However, reforms are needed to improve labor flexibility, lower non-wage costs and simplify the tax system. Colombia's tax evasion rate is close to 30%. The country's finance ministry is claiming that the implementation of electronic invoicing should enable the government to reduce the rate of evasion to 23% this year. Moreover, the finance ministry suggests that a better tax system will help reduce the size of the informal labor market, which the government estimates at 46.5% in major cities. The government projects that the fiscal deficit will narrow to 2.4% of GDP in 2019, an optimistic estimate.

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According to a recent study tax evasion by companies operating in Colombia was responsible for an average annual revenue shortfall of $3.5 billion in 2000-16. In addition, the customs police estimate that contraband and corruption at ports of entry cost the government up to $5 billion per year in lost tax revenue. In recent years there have been a number of allegations of tax officials' involvement in complex contraband, evasion and smuggling structures involving criminal organizations. Since the current government took office, one year ago, 33 tax officials and members of the customs police have been apprehended in connection with contraband seizures.

Over 2019-2020 a gradual adoption of commitments under the OECD membership framework is expected to foster slow improvement in Colombian business competition and intellectual property rights, but enforcement is expected to be limited. A strong legal framework remains, but distortions will lead to the continuation of high differentials between deposit and lending interest rates, and limited long-term financing for medium and smaller sized firms. Inflation is likely to remain within the central bank's 2%-4% target range throughout 2019-23, at an annual average of 3.2%. After three years of above target inflation reflecting the effect of previous tax increases on consumer prices, the central bank has managed to keep inflation inside its target range for 12 months. Inflation is expected to rise over the second half of the year, owing to upward pressure stemming from the latest tax reform, large peso depreciation in April-May and the lagged effect of higher crude prices in the second quarter of 2019. The interest rate outlook for year-end 2019 was revised down to 4.25% from 4.75%, reflecting the global shift toward a more dovish monetary policy.

Security issues and drug eradication will be major priorities for the Duque government in the months ahead. Although currently adopting a more favorable diplomatic tone, the U.S. will continue to demand good results from the Duque administration in the war against drugs. The resumption of chemical spraying of coca crops is a highly contentious issue, particularly domestically. Local communities are opposed to the practice and Duque would have to convince the Constitutional Court to allow the use of certain chemicals as well as engage in close dialogue with the affected communities.

Ecuador

The economy is expected to contract over the coming quarters, as government austerity measures curtail consumption and undermine investment. Policy uncertainty presents an additional risk, as the government's reform efforts face opposition. The consensus is for GDP growth to fall 0.2% in 2019 and expand 0.4% in 2020. This would be the slowest pace since emerging from its last recession in 2016, due to sharp contraction in investment and limited public consumption growth. Public sector spending cuts will drive the recession by pulling back investment and curtailing consumption.

The austerity measures were implemented to reduce public sector debt - which stands at 51.1% of GDP- and to restore fiscal sustainability. While a financing agreement struck with the IMF in February 2019 will provide for the government's immediate financing needs over the next three years, it stipulates that the government enact further spending cuts in order to meet its quarterly deficit reduction targets and avoid a financing crunch. Capital expenditures bore the brunt of government cutbacks, falling 14.5% while spending on wages and salaries fell 0.4%. Public sector wage reductions will feed through to weaker private consumption growth. Consumer confidence has slipped over recent months, and while above the lows seen during the 2016 recession, this suggests that household demand will soften.

Ecuador's president, Lenin Moreno, recently attended the summit of the Pacific Alliance (a regional trade block comprising Chile, Colombia, Peru and Mexico) and obtained assurances that Ecuador can become a full member of the trade block in a year. This will require additional reform efforts by Ecuador to prepare for accession to the group, as well as the conclusion of an as yet non-existent free-trade agreement with Mexico.

President Moreno is playing catch-up. As a former member of the languishing left-wing group of Latin American nations since 2017, Ecuador has been late to integrate with the ambitious group of neighboring countries that launched the Alliance in 2011. Ecuador's former president, Rafael Correa (2007-17), espoused protectionist trade views, vowing to never join the Alliance and frequently butting heads with Colombia and Peru in its role as a member of the Andean Community (CAN). The need to retain market access to the European Union eventually drove Mr. Correa to sign the CAN-EU free trade agreement, creating a basis from which his successor, Mr. Moreno, has pursued stronger market openings for Ecuador.

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Policy uncertainty will likely weaken sentiment among consumers and businesses. While President Moreno is aiming to enact a series of structural reforms meant to liberalize the economy, slowing activity is undermining his political capital and making it difficult for him to advance his agenda. The outlook for tax reform is particularly uncertain. Facing the risk of substantial public opposition, Moreno is pushing back the planned introduction of a tax reform meant to illicit more direct taxes, and ruling out an increase in the VAT. However, given Ecuador's commitment to raising its tax income as part of its financing agreement with the IMF, uncertainty over households' and businesses' tax obligations may reduce willingness to spend and invest.

In addition, Ecuador faces regulatory uncertainty, particularly in the mining sector, given the use of local referenda to attempt to stop new projects. FDI inflows into the mining sector have been a key strength over recent quarters, but the risk presented by public opposition could dampen enthusiasm and weaken the sector's growth outlook. Rising oil exports will offer modest tailwinds over the coming year. During the first half of 2019 real export growth was the sole bright spot, expanding at 3.5%, in line with an increase in oil production. Higher average crude prices have provided additional support with nominal exports growing 6.9% and petroleum revenues up 25.8% in the year through June.

Under the previous left-wing government of President Correa, Ecuador had turned its back on western institutions such as the World Bank and the IMF, relying instead on high oil prices to fund social programs. In addition, Correa for a decade resorted to opaque loans-for-oil deals with China. It was not always clear how much money Ecuador had borrowed from China nor how many barrels of crude it owed in return. Some estimates have Ecuador owing China as much as $40 billion, which is being repaid by crude oil.

Going forward, the country is banking on increased foreign direct investment, particularly in the fledgling mining sector. FDI was worth 1.4% of GDP in 2018. The government aims to double that before leaving office in 2021. Perhaps the most ambitious target in the IMF agreement is on foreign exchange reserves, which currently stands at $4.3 billion and which have seldom in the country's history risen to more than $5 billion. The IMF wants Ecuador to reach the $5 billion figure by the end of 2019; and has set the target of $11.4 billion by the end of 2021.

Dollarization has provided the country macroeconomic stability but has also exposed Ecuador's underlying lack of competitiveness. Reforms are needed to address business environment deficiencies, which include inefficient utilities, legal insecurity, a rigid labor market and low skills levels. The former President Mr. Correa adopted an expansionary fiscal policy 2007-17, facilitated by high oil prices. Current President Moreno faces a much different reality: oil prices will remain modest by the standards of the previous decade. This will force the government to make fiscal adjustments. Ecuador posted a trade deficit of $263 million in 2018 (compared with a surplus of $321 million in 2017), as a pick-up in imports surpassed oil export revenue. The projections are that efforts to boost competitiveness will produce a trade surplus in the years 2019-23.

Peru

Sitting President Martin Vizcarra surprised Peru's 32 million citizens on July 28th while delivering an Independence Day speech. He called on the current congress to end their terms and his a year early by voting to hold a general election in April 2020. The Peruvian president promised to send a constitutional reform bill to congress to bring forward presidential and legislative elections to April 2020; both are currently due in April 2021.

Mr. Vizcarra's gambit is a sign of frustration. He became president 18 months ago, when his predecessor, Pedro Pablo Kuczynski, was forced out of office over allegations that he helped secure public contracts for Odebrecht, the Brazilian construction firm that is accused of bribing officials and politicians across Latin America. President Vizcarra has spent most of his time in office trying to reform the corrupt political and judicial system – which has seen all living former presidents under house arrest, in jail or trying to avoid that fate. Congress, whose largest party is the opposition Popular Force (FC), has tried to prevent some of Vizcarra's reforms from going forward. There currently exists a sense of legislative gridlock as a result. Almost all of the progress made on President Vizcarra's legislative agenda has been precipitated by major political crises. Therefore, bringing forward the elections seems all but inevitable.

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When Ipsos, a pollster, asked Peruvians recently for their views on 16 politicians, just one had an approval rating of higher than 10%. One-third of Peruvians support no politician. President Vizcarra's proposed election, if it happens, would be a leap into the unknown. He knows that the way out of Peru's impasse is better political parties and leaders. Fortunately, the president's election proposal enjoys widespread support among Peruvians. Against that background, it is expected that lawmakers will grudgingly give their support to the president's proposal. In the short-term this will mean policymaking will suffer, as congress will face very tight deadlines to pass the constitutional reform. Political uncertainty in the election run-up will likely serve to deter new investments in the country – until after election results are in.

Nonetheless, the medium-term outlook for Peru, which continues to benefit from solid macroeconomic fundamentals, has not changed. The forecast is that the next administration will largely be guided by economic orthodoxy. A centrist candidate is best placed to win the presidency in 2020. Most regional governorships and district mayoralties in local elections last year were won by candidates who espoused pragmatic, business friendly policies. The consensus is that this continues to be the prevailing sentiment among the electorate who are mostly anxious to see a functioning and dynamic democratic system take root in Peru.

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On June 15, 2019 the government tightened migration policy towards Venezuelans, amid mounting domestic concerns about the economic and security implications of mass Venezuelan immigration. Anti-immigration sentiment currently poses risks to social cohesion inside Peru. GDP growth forecast for 2019 was revised down to 3.4% from 3.7% previously. The trade surplus during January to May 2019, at $1.5 billion, was almost half the surplus for the year earlier, as a result of weaker export prices. A further downward revision has been provided for the trade surplus for 2019-2020. Growth in private sector credit has been solid in recent months owing to favorable domestic financing conditions. At the end of June credit growth was 7.8% in year-on-year terms. The proportion of non-performing assets remain low and credit risk is being mitigated by ample loan-loss provisioning. The central bank has argued for a "wait and watch" approach to monetary policy; if incoming economic data are weaker than expected, this could trigger a rate cut from the current policy rate of 2.75% at which interest rates have been held.

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