Major Country Developments
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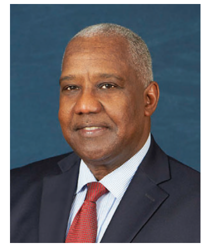

By Byron Shoulton

Overview

An agreement between the U.S., Mexico and Canada to rewrite the North American Free Trade Agreement [Nafta, now renamed the U.S, Mexico and Canada Agreement or USMCA], marks a turning point in U.S. attitude to trade arrangements; while it removes many uncertainties that hovered over companies engaged in trade among the three countries. The new agreement includes rules on technology transfers and provides protection for digital commerce and intellectual property rights which were not included under the 25 year-old Nafta framework.

The U.S. prevailed in getting Canada to open its dairy industry to competition from American and Mexican companies and got all three countries to agree on minimum fixed wage levels in the auto sector. A greater share of auto production will take place in U.S. and Canadian factories, another important concession. Immediately after release of the details of the new agreement major European car companies pledged to increase new investments for auto production in North America. The U.S. has stressed that the changes will succeed in addressing complaints about the original pact and reduce incentives to shift production to Mexico, while boosting manufacturing in the U.S. and could eventually cut the trade deficit with Mexico (which hit $68 billion in 2017). Critics of the new deal call it a managed-trade pact imposing burdensome new regulations on companies doing business in the region, creating new incentives to shift production to Asia.

The USMCA now awaits approval by the U.S. congress and ratification by the Mexican and Canadian parliaments. Meanwhile, U.S. trade with Mexico and Canada continues uninterrupted and expansion or investment plans that were placed on hold pending the outcome of negotiations, can now move forward. All sides appear mostly pleased with the outcome, especially as it retains the full participation of all three countries. The U.S. had threatened to move ahead without Canada if it failed to sign on to the agreement reached with Mexico within a set deadline.

As the U.S. advances negotiations on new trade deals with other traditional allies including South Korea, Japan, and the European Union, a clearer picture emerges of the objective being sought by the Administration: once trade deals are accomplished with traditional allies, a coalition can be formed to jointly address China's violation of international trade practices. Like the U.S. many countries complain of the negative effects of cheap Chinese imports on domestic producers; and resent China requiring foreign companies to freely transfer knowhow and technology in order to do business in China. If the goal of securing new trade deals with allies are achieved, it would put the U.S. in a stronger position to join forces with those countries to face-off with China and push for changes to its behavior desired by this coalition.

U.S.-China relations continue to deteriorate sharply - after the U.S. turned up the pressure by imposing high tariffs on $250 billion of Chinese goods [more than half of all American imports from China]. China responded by imposing its own tariffs on $60 billion worth of U.S. exports to China. Chinese importers are believed to be now avoiding importing U.S. goods where possible. Without progress in negotiations between both countries the U.S. promises to impose additional tariffs on all remaining Chinese exports to the U.S. not yet affected. China laments what it views as U.S. bullying on trade and lack of goodwill in negotiations. China insists that it has repeatedly indicated its willingness to negotiate ways of reducing its trade surplus with the U.S.

The U.S. continues to demand that China comply with rules governing intellectual property rights and technology transfers as it seeks to coordinate support with other countries feeling aggrieved by China's unfair trade and investment policies. If that is achieved, it would strengthen the U.S. bargaining position and would tend to isolate China on this issue.

Separately, China's economy is showing signs of slowing, prompting moves by the authorities to free up more capital for investment while pushing efforts to stimulate fresh consumer demand and spending.

Meanwhile, U.S. farm sector exports to China and elsewhere have borne the brunt of the retaliation against U.S. tariffs; forcing the Administration to create a $12 billion bailout fund to reimburse affected exporters for their losses. In effect, the federal government is buying surplus crops which would have been exported if not for the tariffs. Negative effects on U.S. exports of agriculture, food products, pork, grains, poultry, dairy and intermediate goods- in retaliation to recently imposed U.S. tariffs- includes only a small portion of total U.S. trade output. Nonetheless, U.S. farming enterprises, trading companies, wholesalers and some exporters won't be pleased with this fallout – particularly if it is not short lived.

While the U.S. economy remains strong, manufacturing activity decelerated in September (the manufacturing index fell to 59.8 from 61.3 in August). While key sectors, including sales, production and employment continue to grow steadily, there are signs that the U.S. manufacturing sector could be peaking. Expectations are for manufacturing output to continue to expand at a healthy pace in the coming months, consistent with strong economic growth. Housing market data presents a similar signal. Many believe the housing sector has peaked for the current business cycle and might not add to economic growth the way it has in previous years.

Oil prices climbed above $85 per barrel for the first time in nearly four years as concerns about U.S. sanctions on Iran and optimism over global economic demand propelled the market higher. For the first time since the great recession, more analysts see $90 per barrel oil as a reasonable possibility, laying the basis for a period of higher energy costs. Hedge funds and other money managers have flocked to the benchmark Brent crude oil futures market in recent weeks on concern that Iran's looming supply curtailment, along with shortfalls in Venezuela, could rapidly deplete stockpiles just as global demand move towards 100 million barrels per day. Sentiment received a further lift with the announcement that the agreement to rewrite Nafta has been reached, thereby averting a full-blown trade war and raising expectations for oil demand.

U.S. sanctions on Iran's oil exports are set to take effect on November 4th. The renewed sanctions raise the likelihood of less global crude supply. Frantic deal making now underway by Asian buyers normally reliant on Iranian crude, is indicative of concerns of scarcity among physical crude traders.

Turkey

The weakened Turkish lira and strained U.S.-Turkish relations are fraying one of the most important trade relationships between the two countries – cotton sales. Turkey is the third largest market for U.S. cotton farmers. Some Turkish buyers are holding back on signing contracts after the plunge of the Turkish lira. Some trading companies and international merchants are fearful that existing deals on cotton sales could fall apart.

The lira has fallen by approximately 40% against the dollar this year. That makes importing bales of cotton more expensive as global cotton deals are transacted in dollars. Turkish textile mills can offset part of the effect with exports of fabric and garments to Europe, but high inflation (18%) is hitting domestic consumption. Cotton imports from the U.S. are much less attractive given the steep depreciation of the lira.

Turkey's textile industry is the world's fifth-largest cotton consumer. The country was expected to meet about one-half its demand with imports this year. Approximately 43% of Turkish cotton imports are of U.S. origin. The U.S. sold more than 270,000 bales of cotton to Turkey for delivery in the marketing year that began in August 2018 according to U.S. Department of Agriculture data. Companies making recent shipments between both countries include leading global commodity entities, all well-known names in the market.

Many cotton traders are reportedly hedging the risk of Turkish mills backing out of existing contracts. U.S. cotton sales to Turkey are already disadvantaged by a 3% anti-dumping duty. Nevertheless, the U.S. has historically been the largest supplier because of quantity and the fine quality of its bales. Turkish executives believe U.S. growers could lose market share as long as the two NATO allies remain at odds. Turkish textile mills may instead seek supplies from other exporters such as Brazil, Turkmenistan and Greece. Turkish cotton importers admit that as they place new orders they will choose non- U.S. suppliers because of political reasons. Political tensions have strained the bond between U.S. cotton growers and Turkish spinners. With Turkey's lira and economy under pressure, U.S. tariffs imposed on Turkish steel and aluminum was another body blow to the relationship. President Erdogan has threatened retaliation.

On the other hand, losing Turkish market share of American cotton would be another unwelcome blow to U.S. farming interests. Meanwhile, Turkey is also growing more cotton of its own, reducing its need for imports. The current harvest will give local mills temporary breathing room. In the current environment, a tendency toward smaller purchases from abroad instead of big long-term commitments is the norm given the lira's weakness and tense political relations.

A cloud also hangs over U.S. cotton exports to China since Beijing raised tariffs by 25% to retaliate against U.S. duties on Chinese goods. While delivery to Chinese ports subsided U.S. bales have instead been shipped to Vietnam, where many Chinese companies operate mills. As long as tariffs remain in effect concerns grow that U.S. cotton will no longer be the preferred cotton for Chinese textile mills but likely will become an alternate source.

Central Europe

Strains are emerging in the booming economies of Poland, Hungary, the Czech Republic and Slovakia as unemployment hits record lows and labor shortages start to bite. Since they joined the European Union in 2004 these countries have made huge economic gains matching capital from multinationals with cheap, well- educated local workers.

The transformation of a region scarred by 40 years of communist mismanagement has been one of the EU's biggest successes. Yet as the shortage of workers becomes more acute, that model is becoming harder to sustain, and the region appears to be approaching a crossroads. The previous growth model took advantage of the reserves of labor that were available, and which should have been employed better. Waste under the communist system has taken 25 years to fully re-employ the human capital available in the region. Today the central European countries are facing or slowly approaching the point of insufficient workers to fill demand. This places the need to make adjustments to the growth model squarely on the table for policymakers.

The upside of a successful shift in economic model would be considerable: higher wages for populations who have looked on in envy at the standards of living in Western Europe. But the risk is that if wages rise faster than productivity, the region will not attract the foreign investment that has buttressed its economies over the past two decades.

Talk of labor shortages in central Europe comes as a surprise to many in the rest of the EU, which has seen an influx of migrants from the region in the past decade and has watched many central European leaders strenuously oppose plans to house more refugees. The large number of workers in the UK from countries such as Poland was one of the key underlying issues in the Brexit referendum.

Yet the labor shortages rippling through central Europe are the result of demographic decline and economic success. Having peaked in the late 1900's, the region's population is now shrinking. The trend is likely to worsen. According to UN projections, the combined population of Poland, Hungary, the Czech Republic and Slovakia will fall from 64 million in 2017 to 55.6 million by 2050, or about 13%. Over that period, no region in the world will experience a faster decline.

Meanwhile, economic growth in the region has accelerated, powered by surging private consumption, rock bottom interest rates and billions of euros of funding from the EU. Lured by the prospect of faster growth rates than in Western Europe, foreign investors have flocked to the region, with state of the art factories, steel and glass production facilities, and sleek new shopping centers across the region. These economies are projected to grow an average of 4% this year while western banks and multinationals expand their presence with additional offices and new factories; sometimes shifting production to plants in all four countries. However, the region's ability to supply workers to keep those factories fully operational is approaching its limits.

As of June 2018, 86.6% of industrial companies in Hungary said labor shortages would limit their future output. In Poland the figure was 49.7%, and in the Czech Republic it was 43.2% - in both cases roughly double the level two years ago.

These pressures are fueling a furious battle for staff. Labor costs in Hungary in the last quarter were 10% higher than a year earlier. In the Czech Republic, they were up 9%, in Slovakia 8.5%, and in Poland 8%. In some sectors, the competition has become so intense that it is beginning to disrupt business. There are cases of drivers not showing up for work after being offered better wages by competitors. In the construction sector subcontractors struggle to complete projects on time because of staff shortages. In some cases the combination of surging wages and material costs and the stringent terms on public contracts could force companies out of business. Due to the low unemployment rate people have a lot of opportunities to find work at higher wages, because companies are desperate and are offering sometimes double the current salary to workers willing to change jobs. There are huge pressures for wage increases.

In the short term, the countries in the region are trying to boost their labor supply. Hungary has attempted to do this largely by providing incentives to increase participation levels in the workforce. The government is opposed to using migrants known as a "demographic solution" to address the problem in its labor market.

Others are looking abroad for relief. Poland - the region's largest economy- has gone the furthest. In 2017, Poland issued 1.7 million special short-term work registrations to citizens from its eastern neighbor, Ukraine. It is on course to issue even more such registrations in 2018. Businesses estimate that between 1 million and 2 million Ukrainians are now working in Poland, in what has become one of Europe's biggest, yet least visible, migrations.

Without Ukrainian workers the Polish economy could not keep up with demand for skills and services. Most Ukrainians in Poland are only there temporarily. But with businesses pushing for them to be allowed to stay longer, the government is now working on an immigration overhaul that would allow Ukrainians – and selected other foreigners, mainly from eastern European countries- to come to work in Poland for longer. It is also considering the more radical step of easing rules for workers from some Asian countries, such as Vietnam and the Philippines. Nonetheless, there are growing tensions between the needs of the

Polish economy and negative attitudes towards immigration.

With similar attitudes toward immigrants in the ascendency throughout the region, and given Ukraine's own poor demographic outlook, most observers feel that in the long term, central Europe's best chance of mitigating the impact of its labor shortage will be to shift away from their model of growth based on cheap labor that has powered the region for the past two decades. The alternative would be a formula built on very different foundations: more investment in technology and innovation, higher wages and a more sophisticated education system.

To some extent this shift has already begun. From 2014-16 sales of industrial robots to the region leapt by almost two-thirds, according to data from the International Federation of Robotics. That trend continued into 2018. Some companies have begun to scale back activities in labor-intensive fields such as residential construction and concentrate on projects in rail and hydro-technology that deploy more machines. Such contracts tend to be bigger, needing more of the very productive machines. To sustain such a shift, the region will need more highly-skilled workers. This, in turn, will require local education systems to do a better job of preparing students for such careers, a change that will take time. This pressure to produce higher- skilled workers will become more acute as wages in central Europe edge closer to those in Western Europe, a trend that, while desirable, will also reduce the incentive for multinationals to continue to locate factories in central Europe. Some in the region fear this dynamic could lead foreign investors to shift their investments further east.

Although central European countries such as Poland and Slovakia are relatively attractive for Ukrainian migrant workers, wages in central Europe are still lower than that in western EU member states. Germany is reportedly considering loosening its rules for Ukrainians in relation to seasonal work. If it did so, Polish businesses fear that it could lead to an exodus of Ukrainian workers for some sectors in Poland, e.g. agriculture and construction.

Ecuador

The removal of subsidies, a public wage reduction bill and sharp cuts to capital expenditure will narrow Ecuador's fiscal deficit in the years ahead. Financing requirements and borrowing costs will remain significant, with further fiscal slippage making a potential IMF assistance program increasingly likely over the coming quarters.

The fiscal deficit for 2018 is now expected to narrow to 3.8% of GDP from 4.2% previously, amid sharper than anticipated cuts to capital expenditures. Recently released cuts of $1.3 billion to the budget and some reductions in fuel subsidies comes as the government attempts to rein in a sizable fiscal deficit. The price of 'super' gasoline will rise to international levels, the government will cut the number of ministries from 40 to 20 and will shutter a number of state-owned enterprises. These cost-cutting proposals follow passage of the Production Promotion Law which allows the government to continue to borrow above the constitutionally-imposed 40% of GDP limit, as long as fiscal limits are met. Further cuts and details will likely be included in the 2019 budget which is required to be approved by October 31st.

While the government cuts expenditure, it will continue to grapple with discretionary capital spending [where decisive cuts will weigh on overall investment growth]. Through to May 2018, capital expenditure fell 42.7% y-o-y, from $3.8 billion in 2017 to $2.2 billion in 2018. The central government bore the brunt the cutbacks, with its share of capital expenditure reduced by 62.4% according to the finance ministry. As a result the fiscal deficit is forecast to narrow gradually over the coming years.

Oil prices will support Ecuador's revenue growth, despite economic headwinds. Supported by rising global crude prices oil revenues are forecast to rise to $7.2 billion and $8.4 billion in 2018 and 2019 respectively, from $5.8 billion in 2017. However, public sector cutbacks will limit economic growth and reduce income tax and VAT intakes. The expectation is for revenue growth of 5.4% y-o-y and 4.3% in 2018 and 2019 respectively, down from 10.3% in 2017.

Rising financing costs are deemed unsustainable. President Moreno announced that the country's debt load was approximately $60 billion, or just below 60% of GDP. As yields on Ecuador's sovereign bonds hover around 10%, the finance ministry has avoided tapping international debt markets in recent months, instead drawing $700 million from two state-owned electric utilities in June and July. However, this is not a sustainable revenue source and the government has announced it will receive $1 billion from an unspecified investment bank and a loan for construction of the Quito subway. High borrowing costs have resulted in interest payments reaching 6.8% of total revenues over the 12 months through May 2018. With the government continuing to rely on external financing, it is expected that these payments will consume a rising share of government intakes in the coming quarters. Ecuador was downgraded to B- by ratings agency Fitch on August 17th. Chinese loans account for a significant percentage of Ecuador's foreign debt. These are being repaid with crude oil exports to China, which limits some of Ecuador's crude production sale on the open market.

With financing requirements forecast to remain in the billions of dollars in 2019 and bond investors requiring prohibitively high yields, the government of Ecuador may soon have to turn to the IMF. The Moreno administration has reportedly been in discussions with the multilateral institution in recent months, and further fiscal slippage would make the government increasingly likely to request an assistance package.

A public backlash could weigh on the government's ability to push through further cuts going forward. Austerity measures meant to reduce both the public sector wage bill and subsidies will likely erode the government's public support. President Moreno's approval rating has already fallen to 45.9% as of July 2018, down from 70.3% a year earlier. If his support falls lower policy making will become increasingly difficult.

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