Major Country Developments
May 2018

Overview

By Byron Shoulton

U.S. inflation hit the important 2% milestone allowing Federal Reserve officials to consider fresh evidence on whether economic expansion is finally rousing dormant consumer prices. The Fed now says that price growth has moved close to its target and is likely to stay there over the medium term. Markets strongly expect the Fed to lift interest rates gradually over 2018 in an attempt to prevent the U.S. economy from overheating, and instead move at a steady pace. The recent jump in the cost of a barrel of oil is also adding heat to price growth. In addition, official figures show a 2.9% growth in private sector wages and salaries during the first three months of 2018, compared with the same period a year earlier. This represents the fastest pace in wage gains since 2008.

The median forecast from the Fed's most recent projections points to a total of three interest rate increases this year. Some are expecting four upward moves. Fed forecasts show short-term interest rates peaking above 3% by 2020. The bullish outlook is being driven in part by the robust U.S. labor market, where unemployment is projected to fall as low as 3.6% in the coming years from its current 3.9% rate. New jobs added by the private sector in April registered a strong 204,000, continuing the trend of recent months. Last December's tax cuts, coupled with higher limits on public spending this spring, will likely bolster U.S. economic growth going into the second quarter. However, rising trade tensions between the U.S. and its trade partners are clouding the picture for central bankers, companies and traders alike. Executives at some U.S. companies are becoming unsettled by the Administration's saber-rattling over trade. The Institute for Supply Management (ISM) index of U.S. factory activity slowed for a second straight month in April; while the U.S. expansion lost some of its momentum in the first quarter as consumers reined in spending on cars and other products. Still, growth was quicker than the 2% annualized rate that was forecast. GDP rose at a 2.3% annual rate in the first three months of 2018, a slowdown from 2.9% expansion registered in the final quarter of 2017.

Global supply chain constraints are reportedly restricting production across industries. From heavy equipment manufacturing to shale production operators - all report shortages of materials, workers and congested pipelines. In the U.S., freight haulage including railways and trucking companies are reporting very tight capacity. The Institute for Supply Management's index measuring backlogs of orders in manufacturing reached its highest level since 2004. Set against a background of robust demand, supply chains are struggling to keep up.

In Europe, where the recovery is a couple of years behind the U.S., the IHS Markit purchasing managers' index shows delivery times close to the longest in 20 years. A European Commission survey shows a sharp rise in Eurozone businesses reporting labor and equipment factors limiting production. The Chinese manufacturing PMI also shows rising backlogs of work in recent months, although to a lesser extent.

On both sides of the Atlantic, unemployment has already fallen a long way, so greater investment in labor-savings plants and technology will be key to keep the supply problems from feeding into prices. Such spending might boost productivity, allowing for higher wage increases and perhaps boosting potential growth, keeping central banks from tightening policy faster than markets currently expect.

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Oil prices

With healthy global growth driving a strong increase in the demand for oil, the glut that sent prices lower in 2014-16 has been drained away, laying the foundation for crude prices to rise. Crude has been driven higher by a combination of restricted supply, strong global demand and international tension, [including heightened concerns about the future of the international agreement on Iran's nuclear program].

At around $75 per barrel, oil is at a level that many producers and consumers mostly find tolerable. However, Saudi Arabia seem tempted to push the envelope a bit to boost prices to $80 or $100 per barrel. In April it was revealed that the Saudis while pleased with recent price increases (which enables the kingdom to cover government spending from tax revenues, after 3 years of belt-tightening) would like to cut production further to boost prices and help pep up the planned flotation of Saudi Aramco.

Allowing oil prices to rise that far would be a mistake. The International Monetary Fund warned that rising oil prices have not yet prompted downward revisions to global growth forecasts, but that view was based on an assumption that crude would average about $62 per barrel in 2018 and $58 in 2019. If prices are substantially higher, the impact on growth would likely become more severe. Higher crude prices may encourage consumers to use less and also stimulate investment in oil supply, not least in the U.S. shale industry, which is already running red hot.

U.S.Tariffs

The U.S. withheld imposition of tariffs on imports of steel and aluminum from the European Union, Canada, Mexico, Argentina, Australia, Brazil and South Korea – extending the existing rules for at least another month. The move to delay the tariffs gives Washington breathing room with its allies as it tries to assemble a coalition to take on China over its intellectual property practices among other complaints. More than a dozen countries have complained about the unilaterally imposed U.S. tariffs to the World Trade Organization, leading the WTO's director general to call for restraint and urgent dialogue as the best path forward to resolve these problems.

The countries which the U.S. agreed to temporarily exclude from tariffs, all made the case that their metal exports do not impair U.S. national security, the legal basis for the tariffs. Some countries threatened retaliation, an approach that seemed to work. For example, Brazil and Australia explained that exports of semi-finished steel help rather than hurt U.S. industry. Brazilian steel slabs feed an Alabama plant that rolls finished metal for the U.S. southeastern auto industry. Brazilian companies buy Alabama coal used in the coke that are used in plants in Brazil. Similarly, Australian steel officials argued that their steel do not weigh on workers in Ohio or Pennsylvania since Australian steel is mostly shipped to facilities located on the U.S. west coast. The Australians argue that if they couldn't import hot-rolled coil from Australia for use in their California based plant they would be forced to transport supplies through the Rocky Mountains from their Ohio steel works at three times the cost. Canada's metals industry is closely integrated with the U.S., prompting American firms and workers to request an exemption for Ottawa.

South Korea's exemption from the steel and aluminum tariffs was necessary as that country is currently negotiating amendments to its own U.S. trade agreement. South Korea is the biggest importer of China's steel and a top source of U.S. imports, and the American industry has singled out South Korea for transmitting China's steel glut outside Asia. While South Korea got an exemption, many complain that Japan another top Asian ally, wasn't accorded an exemption. Japan has so far avoided threats of retaliation, saying instead that it will react calmly and seek consultations with the U.S. via the WTO.

Euro-zone

While U.S. growth remains fairly robust, the euro area economy recorded its slowest expansion in 18 months during the first quarter. The European Commission in its latest projections for growth maintained its forecasts for growth of 2.3% in 2018 and 2% in 2019; while insisting that the recent bad run of data was due to "temporary" factors. However, it warned of the threat to regional expansion from U.S. trade policies. The Commission pointed to the risks of a nexus of protectionist economic policies, higher Fed interest rates and the prospect of a trade war that could spook markets and European businesses. It argued that the materialization of these risks could throw euro zone expansion off track. Strong euro-zone growth over the past two years have been reliant on strong exports and a boost in investment growth.

After years of austerity, 2018 marks the first year that all 19 euro-zone countries meet Brussels' demand that their public spending deficits do not exceed 3% of GDP. France and Spain were the last two countries to bring their deficits below the ceiling, reducing them to 2.3% and 2.6%, respectively in 2017.

One of the most sweeping overtures the EU has made so far to Washington on trade has been the recent acknowledgement of shortcomings in the World Trade Organization. The EU has said that it is ready to negotiate major reforms to the international trading system once the U.S. dropped its threat to impose punitive steel and aluminum tariffs on EU exports. Meanwhile, France, Germany and the European Commission have stepped up calls for permanent relief from U.S. tariffs, with Brussels warning the U.S. that it will not negotiate under threat. The Europeans have stressed that the threat of tariffs prolongs market uncertainty, which is already affecting business decisions at home and abroad. Being granted a temporary exemption from proposed tariffs by the U.S. is seen by European allies as inadequate. The global tariffs proposed by the U.S. risk alienating allies and trading partners locked in negotiations with Washington, all at a time when U.S. officials are seeking to isolate China over its trade practices.

US-China

China appears frustrated by threats from the U.S. to impose tariffs on $150 billion in Chinese goods and is dismayed by suggestions in the West that China has a weak bargaining position. The thinking among Chinese officials is that their country's strengthening economy, its one-party political system and President Xi Jinping's grip on power – especially after the repeal of presidential term limits in March – mean that China can stand up to the U.S. in a trade quarrel. Meanwhile, the Chinese have indicated that they will be willing to further open the country's financial and automotive sectors to foreign participants. Chinese officials also suggest that they are willing to tighten intellectual property rules so as to foster innovation within China as well as protecting foreign technologies from counterfeiting and other illegal copying. However, China is insisting that the parameters of any negotiations be limited, and that tariff threats be removed before a final deal can be struck with the U.S. Chinese officials are persuaded that U.S. demands are an attempt to stop China's economic development and technological progress. In some respects, the hard stance being taken by Chinese officials reflect a hardening of public attitudes in China. The hardline taken by the U.S. toward China is seen by Chinese citizens as overly aggressive, bordering on bullying - a view that is shared in Chinese official circles.

In mid-April, the U.S. barred American companies from selling their wares to a Chinese telecom equipment maker, ZTE. The move is seen as potentially crippling to the Chinese company, which needs U.S. chips and software to power the smartphones and equipment it sells around the world. In Washington ZTE was cited for repeated violations of sanctions against Iran and North Korea. Legislation working its way through Congress would give the Committee of Foreign Investment in the U.S. (CFIUS), which examines inbound investments for potential national security threats, the power to review required joint-ventures arrangements for foreign investments of any U.S. company in China. The U.S. Treasury is also working on other investment restrictions to block Chinese companies from investing in U.S. sectors that American companies are banned from buying into in China. One way that China could address this U.S. concern would be to remove existing restrictions on inbound investments and abolish equity caps for foreign companies altogether.

NAFTA/Mexico

The U.S. Administration is actively seeking to reach an agreement on a new Nafta deal as early as possible. The energy sector is attractive to Washington because in recent years the U.S. has begun exporting more energy to Mexico than it imports, reducing the U.S. trade deficit with Mexico – a major goal of the Trump Administration.

When Nafta was first negotiated in the 1990's, few provisions pertained to the energy industry. Mexico's constitution at the time blocked foreign energy ownership. In 2013 the Mexican constitution was amended to open the energy sector – just as U.S. oil and gas production began to soar. Foreign investment has since poured into Mexico's energy sector. The Mexican government has since held nine auctions for oil blocks that are sparking billions of dollars in investment. Foreign companies also began to buy gas stations and sell directly to Mexican consumers in an 800,000 barrel-a-day market. Pipelines are being built across the U.S.-Mexico border and Mexico is buying increasing amounts of U.S. natural gas.

This explains why certain U.S. companies are at odds with the Administration over a proposed rule change to NAFTA that would endanger the energy bright spot. All three NAFTA countries U.S., Canada and Mexico – agree that a new treaty should aid energy trading. All three NAFTA partners are energy producers and exporters. Under consideration are initiatives to ease the construction of pipelines across borders, to aid U.S. exports of natural gas and to assist U.S. companies opening gas stations or exploring for oil in Mexico.

The proposals would also prevent Mexico from reversing itself on the liberalization of its energy sector at a time when U.S. companies are playing a growing role in Mexican energy. American businesses, including some energy companies, are balking at Washington's pursuit of an unrelated rule change that would weaken or end Nafta's protection of U.S. investments in Mexico or Canada from government intervention.

At issue is the so-called Investor State Dispute Settlement, which allows a U.S. business to take legal action if a foreign government harms the company's investment in that country. For example, if Mexico nationalized a U.S.-owned oilrig in Mexico, the measure would give the American company the right to appeal to adjudicating panels set up under Nafta.

The protections are valued by a variety of U.S. industries, from manufacturing to financial services. They are particularly vital to the U.S. energy sector. Energy sector investments typically require substantial investment before the first barrel of crude is produced. The U.S. Trade Representative is proposing that the three Nafta member countries eliminate the Nafta protections, saying that they create incentives for U.S. companies to invest internationally and move jobs overseas. U.S. business interests are lobbying to pressure the Administration to retain the protections, arguing that they ensure American investors, businesses and their workers will be treated fairly overseas. Canada and Mexico also object to the Administration's proposal.

Some American companies are threatening to withhold support of a re-negotiated treaty because of the importance they place on the dispute settlement. Such a scenario could complicate winning congressional support to complete a new Nafta deal, given business groups have many sympathetic voices in Congress. Energy and digital trade were two areas where most thought it made sense to upgrade Nafta and to pursue a new agreement. However, the international dispute settlement is one area that a majority of U.S. entities believe should not be changed.

Meanwhile, Mexican President Pena Nieto is anxious to solidify his energy market opening initiatives ahead of presidential elections due on July 1, 2018. Many believe the frontrunner, Andres Manuel Lopez Obrador, might try to roll it back. Mr. Lopez Obrador has indicated he would hold back on any new auctions of oil blocks while he reviews exiting energy contracts to ensure they are benefiting Mexico.

By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at bshoulton@fcia.com

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