STICKY NOTES BY THE IIF

Welcome to Sticky Notes, the IIF's new weekly look at the big events we're watching in international economics and politics. We hope that it's an interesting and insightful addition to the great work already produced by the IIF – but let us know what you think by sending us an email here.

This week:

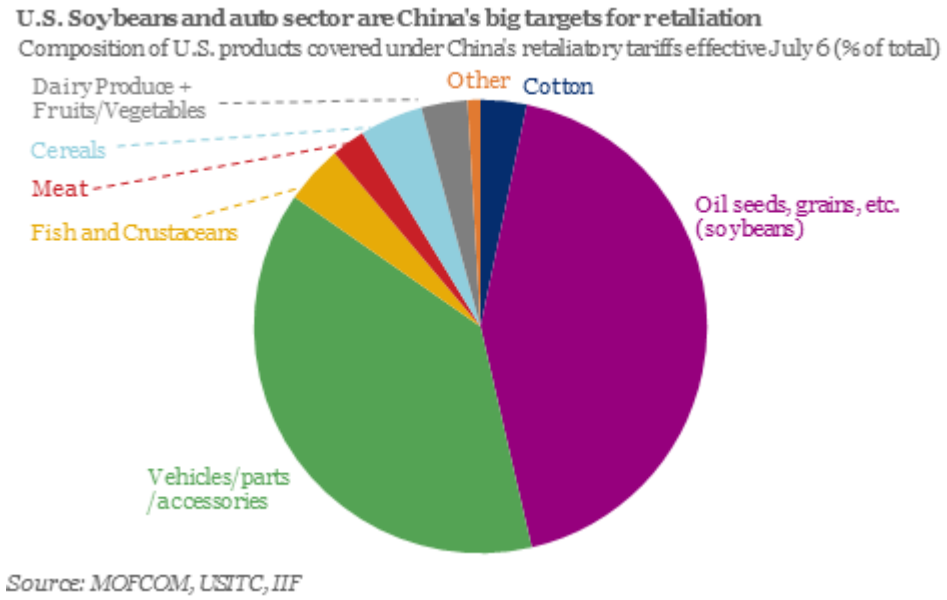
- Scott Farnham breaks down the latest escalation of trade tensions between the U.S. and China.
- I reflect on Kim Jong Un's trip to China and the Singapore summit between the U.S. and North Korea.
- We preview an upcoming note on the OPEC meeting in Vienna by our head of MENA research, Garbis Iradian.
- IIF Deputy-Chief Economist Sergi Lanau brings you up to speed on the situation in Brazil and potential contagion in emerging markets.

As always, thanks for reading and please follow along on Twitter: @IIF

U.S.-China Trade Dispute and Implications for the Midterms

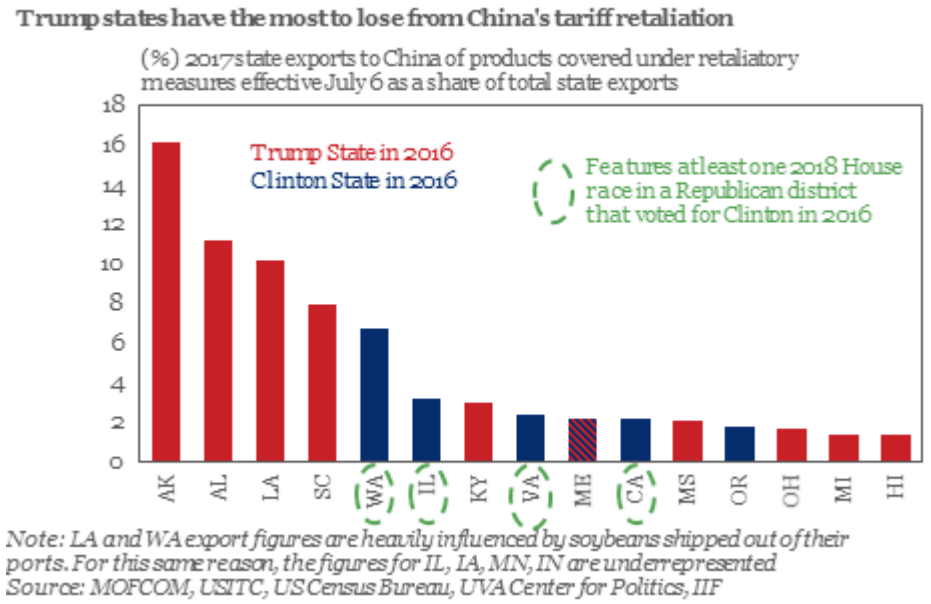
A promise or a threat? The Trump Administration is moving ahead with plans to slap 25% tariffs on $50 billion worth of Chinese imports related to its Section 301 investigation into China's IP practices – tariffs on roughly $34 billion worth of products will go into effect on July 6th, while the remaining $16 billion will be implemented following further review and a public comment period ending July 31st (Mid-August/September is a plausible target date). China will also follow through with its threat to retaliate with measures of "equal scale and equal strength", announcing two lists of imported U.S. products worth $34 billion and $16 billion to be hit with 25% tariffs as soon as the U.S. tariffs go into effect.

China hits back at key sectors. While the macroeconomic impacts of the impending tariffs appear minimal as an overall share of the two economies – and the knock-on effects can be debated – the potential impacts on individual companies, whole sectors, and the states that house those sectors make for interesting storylines. China's initial retaliation list of 545 U.S. products predominantly targets the U.S. soybean and auto sectors. Those two categories combined for about $24 billion imports to China last year, with balance of this initial round of tariffs spread over a variety of other U.S. agricultural goods and seafood like Maine lobster.



Which states are the stress points? We used the Census Bureau's state commodity trade data to drill down on which states export the 545 products to China that will fall under the proposed tariffs. Looking at the share of total state exports impacted, states that voted for Trump in 2016 will feel it the most – the apparent strategy of China and other countries looking to retaliate against U.S. tariffs.

Looking ahead to the U.S. midterm elections in November, Democrats only need to win an additional 24 seats to take control of the House, so expect them to amplify any negative effects from Trump's trade agenda with the hope of stealing a race or two in Trump country. Of the blue states affected, Washington, Illinois, Virginia, and California all have at least 2% of exports targeted by China's tariffs and collectively feature 10 House races in Republican-held districts that voted for Clinton – this could get interesting.



More than Meets the Eye in North Korea

China sends a message. Meanwhile, this week's visit of North Korean leader Kim Jong Un to China seemed designed to remind the U.S. administration that they need China's help with North Korea.

Critics of the Summit have pointed out that the North Korean commitment to "work toward complete denuclearization of the Korean Peninsula" was vaguer than commitments made by North Korea in 1994 and 2005, and that if negotiations don't pan out, the U.S. will need China's help implementing new sanctions.

Trump flips the script. For the most part, the Trump Administration has brushed off complaints about the process. Privately, they say that they are testing a new theory of North Korea negotiations. In their view, Kim Jong Un isn't his father; he is young – in his mid-30s – and has concluded that he can't keep the North Korean state intact indefinitely under the current system. They believe that, domestically, he needs a face-saving way to transition to a more open system. In particular, before negotiating he needs

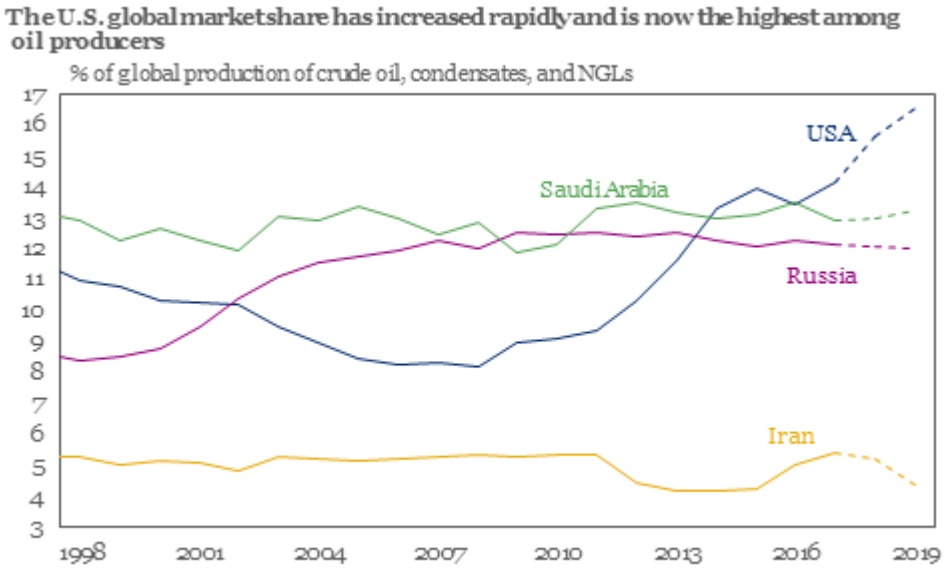
to show that he has successfully leveraged the North Korean nuclear program to earn status and prestige. They say that President Trump's fawning Singapore statements about Kim, and his willingness to accept half a loaf on the statement, were designed to give Kim room to negotiate.

The proof will be in the pudding, of course. The Singapore statement committed both sides to "implement the stipulations in this joint statement fully and expeditiously." By the end of the summer, both sides should have agreed to a specific timeline for implementation, at least. If that hasn't happened, the U.S. will be going back to international partners, and particularly the Chinese, for assistance implementing tougher sanctions.

OPEC Meets in Vienna

Look for an upcoming piece by Garbis Iradian, who will be analyzing the outcome of the decision by OPEC to end their current production cut agreement. OPEC members debated responses to higher oil prices, reflecting, among other things, the unplanned supply disruption in Venezuela.

The agreement to increase production by about one million barrels per day will bring Brent oil prices well below $70 per barrel by end-2018. The Saudis favored the agreement as a way to curry favor with the Trump Administration and to keep pressure on Iran. For the Russians, lower prices will help address concerns about the U.S. increase in global oil market share as higher oil prices stimulate further increase in shale production.



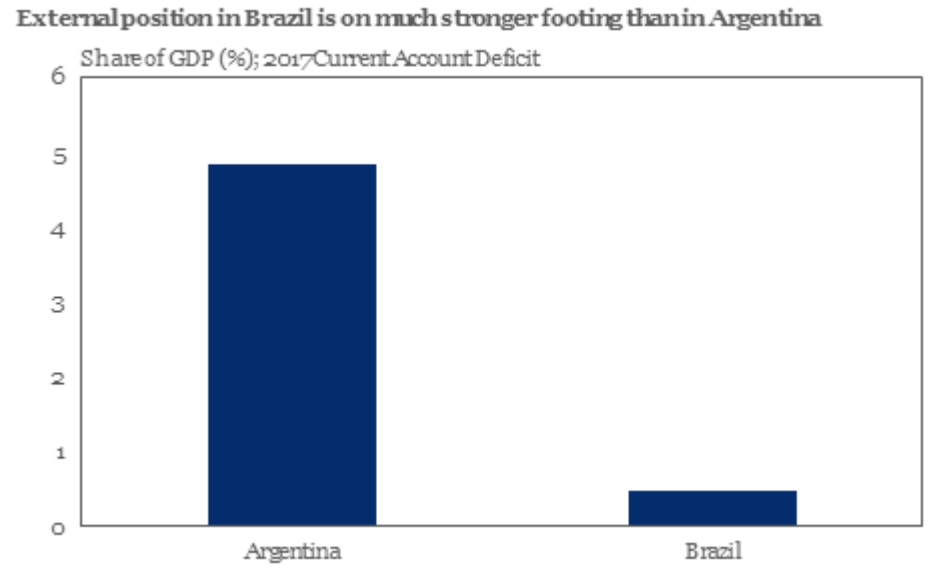
Source: BP and IIF calculations and forecast.

The *Real* Situation in Brazil

What's going on? Brazil is under market pressure, with the Real down 11% against the US dollar this year. Domestic factors such as the challenge in implementing reforms and a truckers' strike explain part of the weakness, but contagion from the crisis in Argentina is also at play.

Argentina is a main export destination for Brazil. As the Argentine Peso falls (-31% vs. USD year-to-date), the Brazilian Real also needs to depreciate to keep Brazil's competitiveness unchanged. Another reason for the Real to fall is that Argentina and Brazil compete in export markets such as Europe and China, where the relative value of a country's currency can make a difference.

Should we be worried? Despite signs of contagion, Brazil's external position is an order of magnitude stronger than Argentina's and reserve buffers ample. Beyond the external sector, Brazil's economic fundamentals are generally good. Inflation has fallen sharply in the last two years and the economy has left behind the long recession of 2015-16. The fiscal position is weak but external public debt is very low. With the IMF program for Argentina taking some of the pressure off, Brazil appears to be on better footing – but certainly not out of the woods yet.



Source: Haver, IIF