STICKY NOTES BY THE IIF

Welcome back to Sticky Notes, the IIF’s new weekly look at the big events we’re watching in international economics and politics. As always, we’d love to hear from you with follow-up questions or comments. Send us an email here.

This week:

- Our head of research for Turkey, Ugras Ulku, recaps the recent election
- I provide an update on the confusing headlines about U.S. investment restrictions
- Scott Farnham dives into the trade data to show who in the U.S. gets hit by retaliatory tariffs
- The head of our Brussels office, Robert Priester, previews this week’s EU Summit
- Martín Castellano, head of LATAM research, looks at the upcoming Mexican presidential election and what that means for NAFTA

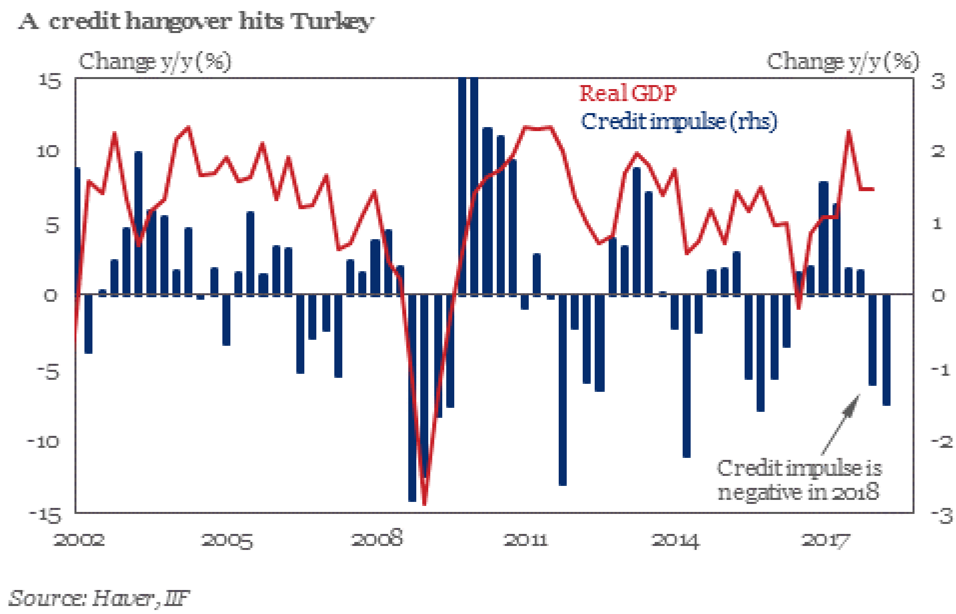
As always, thanks for reading and please follow along on Twitter: @IIF

Turkish Delight?

Erdogan's surprise win. In recent weeks, a second round in Turkey's Presidential election was looking more and more likely, with the opposition to President Erdogan looking increasingly competitive at that stage. It didn't come to that. Over the weekend, in a complete surprise to news agencies and financial markets, President Erdogan won the first round of the vote, making a second round unnecessary. And although his party lost its majority in Parliament, there seems to be little doubt that – with new executive powers bestowed on him in this election – President Erdogan has taken another step towards consolidating power in Turkey.

Questions remain. There are two big questions looking ahead. First, in the run-up to the election, markets punished President Erdogan for his unorthodox approach to policy, in particular his assertion that he would take a more active role in setting monetary policy after the elections. There is the possibility that these kinds of remarks were essentially pre-election posturing, playing to a domestic audience, and that policy-making will return to a more traditional approach now that President Erdogan has accomplished his objective. Markets are betting on this to some degree, with the Lira rallying in recent days. Second, regardless of the policy setting, there are some economic realities that even more orthodox policies won't be able to change.

Credit hangover awaits. In the run-up to the election, President Erdogan essentially pump-primed the economy, most obviously through a very sizeable credit impulse via the government's Credit Guarantee Fund (CGF). That fund boosted bank lending significantly in 2017, contributing significantly to Turkey's outsize growth of 7.4 percent in 2017. The flip-side of such a stimulus is that growth this year is likely to be weak, a hangover if you will. The other issue is that the pump-priming of the economy widened the current account deficit substantially, adding to depreciation pressure on the Lira. Turkey's biggest advantage looking forward is – paradoxically – the currency. Unlike the Argentinian Peso, the Lira has been allowed to weaken steadily, falling a whopping 22 percent against the Dollar year-to-date. This decline has let off steam, helping the economy navigate uncertain domestic policies and rising G-3 rates. Coming months will show whether the corporate sector – which has borrowed heavily in foreign currency – is able to adjust to the new set of realities. For the time being, the flexible (and weak) Lira is good news.



U.S. Investment Restriction Confusion

Back and forth. Several outlets reported this week that the Trump Administration was considering an Executive Order (EO) to block Chinese investments in companies in certain industries and to tighten export control rules to prevent transfers of sensitive technologies to China. These measures have been under consideration since the President launched an investigation against Chinese trade practices in August 2017.

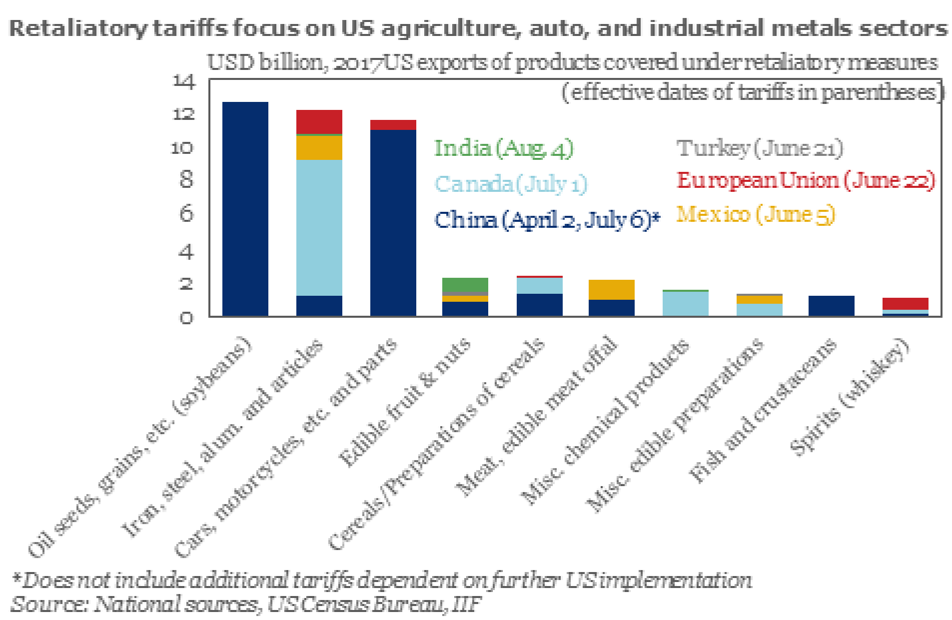
We now understand that President Trump has rejected the proposed EO as too categorical and potentially overbroad. Some Administration officials argued to the President that the EO could be used to bar investment in areas that don't pose a genuine national security risk. Administration lawyers also raised the concern that the EO, which would have relied on the International Emergency Economic Powers Act (IEEPA), would have been vulnerable to legal challenge – putting many other Administration actions under IEEPA at risk, including a number of U.S. sanctions regimes.

Congress set to act. Instead, the Administration will focus on strengthening the Foreign Investment Risk Review Modernization Act (FIRRMA). FIRRMA is draft legislation to reform the Committee on Foreign Investment in the United States (CFIUS), which reviews inbound investment for impacts on national security. The Senate's version of the bill is included in the National Defense Authorization Act (NDAA) which is must-pass legislation that will soon be considered in a House-Senate conference committee. The House adopted its version of CFIUS reform earlier today. The Administration will likely weigh in with the conference committee to preserve as much of the Senate version of FIRRMA as possible – perhaps to allow for review of passive investments – and then intends to take administrative action under the new law to limit Chinese investment in sensitive industries.

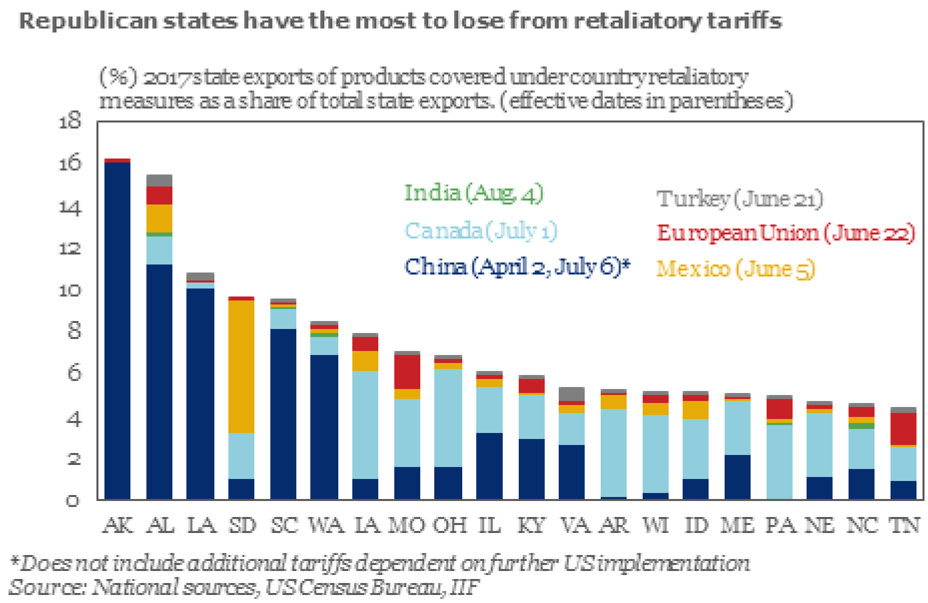
U.S. Trade: Retaliatory Measures Start Adding UP

EU hits back. Last Friday, the EU began implementing tariffs in response to the US tariffs on steel and aluminum, which went into effect on key allies at the beginning of June. While the dollar amount of the U.S. exports within scope is relatively small (near $3.5 bn), the politically motivated targets have made headlines this week following Harley Davidson's announcement that they will move some production overseas to escape the new tariffs. This is only the beginning.

Canada and China prepare to strike. Canada's retaliatory tariffs, impacting about $13 bn of U.S. exports consisting of industrial metals and politically sensitive consumer goods, are scheduled to go into effect on July 1st. China's retaliation, initially targeting about $34 bn of U.S. products like soybeans and the auto sector, will be implemented on July 6th pending implementation of the U.S. tariffs related to the Section 301 investigation on IP issues. Taking into account other countries that have announced specific product lists and dates of implementation for retaliatory tariffs (Mexico, Turkey, and India), nearly $60 billion U.S. exports – concentrated in the agriculture, auto, and industrial metals sectors – will be subject to retaliatory tariffs by August 4th, with more from China on the way depending on how the U.S. proceeds.



Trump Country in the crosshairs. Building on our analysis last week of China's proposed tariffs, we used the Census Bureau's state commodity trade data to find which U.S. states export the products that fall under the retaliatory measures. Rather than show the gross dollar amounts of exports impacted which tends to skew towards big state economies, we looked at the impacted exports as a share of total exports. By this metric, Alaska will be hit hardest as a result of China's impending tariffs on its seafood exports. Alabama is a close second, as its vehicle exports were targeted for retaliation by multiple countries.



Republicans speak up. Given the sectors impacted, and the announced strategy by the countries implementing these tariffs, it is unsurprising that only 4 states (WA, IL, VA, ME) out of the top 20 impacted voted for Clinton in 2016. Targeted industries in impacted states have contacted members of Congress, who are now referencing close-to-home stories of the effects of the President's trade actions in their talking points. Commerce Secretary Ross received a bipartisan condemnation of the tariffs on allies from the Senate Finance Committee last week, and there are now multiple Republican-led efforts underway to pass legislation to restore Congressional authority over tariffs and rein in the scope of the national security definition under Section 232 of the Trade Expansion Act of 1962 – the grounds for the steel and aluminum tariffs and ongoing investigation into automobiles. It is too early to gauge broad appetite for those proposals.

Looking ahead to the EU Summit

Economy is a bright spot. European heads of government meet in Brussels Thursday and Friday in the European Council. In the backdrop, the European economy continues to grow at a healthy pace. Quarterly growth has averaged about 2.5% over the past year. 2017 annual growth was 2.7% - a 10-year high - and the overall unemployment rate is down near pre-crisis levels. Chancellor Merkel and President Macron have come to an agreement on Eurozone reform, including plans for a common Eurozone budget starting in 2021 and a new European Stability Mechanism, which would be designed to assess economic conditions in Member States and help stem future financial crises. Twelve Member State Finance Ministers have expressed opposition to the plan and so it will be up to Macron and Merkel to persuade their counterparts, but it's hopeful that the two largest economies are coming to agreement on the central issues impacting the future of the European economy.

Though while the economics are looking up, the politics remain as challenging as ever.

Merkel needs a migration deal. One under-reported story, in our view, is the challenge to the CDU-CSU coalition in Germany over migration policy. The coalition is under strain following a CSU call to reverse Merkel's immigration policies and turn away asylum seekers at the border. In hopes that a common European agreement on migrants would help settle the debate, Merkel convened a mini-Summit over the past weekend, which failed to produce an agreement. Discussion will continue Thursday and Friday. Failure to reach agreement could exacerbate coalition tensions and raise the risk that the coalition collapses, though the prospect of new elections (and a stronger AfD) is likely to keep all parties talking.

Finally, Brexit slides down the agenda. While Brexit was expected to be a primary item for discussion, the absence of tangible progress in the negotiations has left leaders with less to talk about. Odds are rising of ‘no deal’ and a UK departure without a transition period or any outline to the future trade agreement, prompting financial services authorities to urge – yet again – that firms take necessary precautions. Businesses on both sides of the Channel are becoming more vocal in their calls for clarity on future arrangements and a transition period.

Countdown to Election Day in Mexico

AMLO poised for victory. Mexico’s July 1st presidential election is less than a week away. The left-wing candidate, Andrés Manuel Lopez Obrador (AMLO), has a 10-20 point lead in recent polls. Barring an election day upset, he will take office December 1st. AMLO has run on a campaign of increased state intervention in the economy, though Mexico’s fragmented political system, institutional checks and balances, and significant exposure to market forces will likely constrain his ability to introduce a radical policy shift. Our assumption is that AMLO will maintain the current macroeconomic framework. However, we could see attempts to direct credit to certain sectors such as agriculture, increase investment requirements in the energy sector, and halt implementation of the education reform. The main risk is to face a gradual erosion of the economic fundamentals in the absence of forceful and upfront measures to gain investor confidence.

What about NAFTA? It’s hard to see a path to a NAFTA agreement. Despite creative compromise proposals from Mexico on rules of origin, the parties have been unable to find common ground. The U.S. also remains committed to a sunset clause, which is opposed by both the Canadians and the Mexicans, and to changes to the Chapter 19 dispute settlement mechanism, which is a non-starter for the Canadians. Between now and December, President Peña Nieto's Administration will stay in place, though with limited capacity to cut a deal. Although AMLO has expressed support for NAFTA, post-December he is likely to take a more combative approach to negotiations than his predecessor. Moreover, Republicans are likely to lose seats in the House in the U.S. midterm elections, making Congressional passage of any new NAFTA deal less likely. At some point, we expect discussion to shift to changes the Trump Administration can make to NAFTA within the current implementing legislation.