STICKY NOTES BY THE IIF

Welcome back to another edition of Sticky Notes, the IIF's review of this week's events in international economics and politics.

We love to hear from readers, so send us your thoughts or questions. You can reach us here. Next week, we plan to look auto tariffs as well as the Trump-Putin Summit. If you have any thoughts, please let us know.

This week:

- The head of our London office, Matt Ekberg, gives us an update on Brexit.
- Scott Farnham provides an update on the U.S.-China trade dispute.
- I highlight the findings from our latest Global Debt Monitor, including a surge in government debt.
- Sonja Gibbs takes a look at President Macron's reform initiatives in France.
- Dylan Riddle's Tweet of the Week

Thanks for reading,

Kristen

Brexit: An Eventful Week

White Paper published. Prime Minister Theresa May's government published its White Paper on Thursday, expanding on the so-called July 6th "Chequers Agreement" – which outlined the UK's proposal for its future relationship with the EU. Under the terms of the Paper, the UK will formally ask the EU for a post-Brexit "association agreement" – including a "free-trade area" for goods and agri-business – alongside a security partnership and continued membership of many EU agencies. Under the terms of the proposal, the UK would abide by the EU's common rulebook for regulation and product standards for goods to protect supply chains.

On financial services, the UK would no longer operate under the EU passporting regime, but would instead pursue an "enhanced equivalence" arrangement to encompass a broader range of cross-border activities.

Headwinds persist. The Chequers Agreement and subsequent White Paper have run into opposition on all sides. EU officials have argued that much of the cost of goods is related to regulation of aspects other than goods (i.e. labor, services, etc.) so the UK's approach would not result in a level playing field. Meanwhile, prominent "Brexiteers" came out in opposition to the deal, noting that it crosses several "red lines," including the continued oversight of some UK rules by the European Court of Justice (ECJ). Theresa May's Brexit Secretary, David Davis, and her Foreign Secretary, Boris Johnson, both resigned the cabinet in opposition to the Agreement. The Agreement also may inhibit the ability of the UK to cut favorable trade deals with third countries if regulatory terms for goods and agriculture are fully aligned with the EU and are outside the scope of bilateral trade negotiations.

Next steps. Brexiteers will now look to modify the proposals of the White

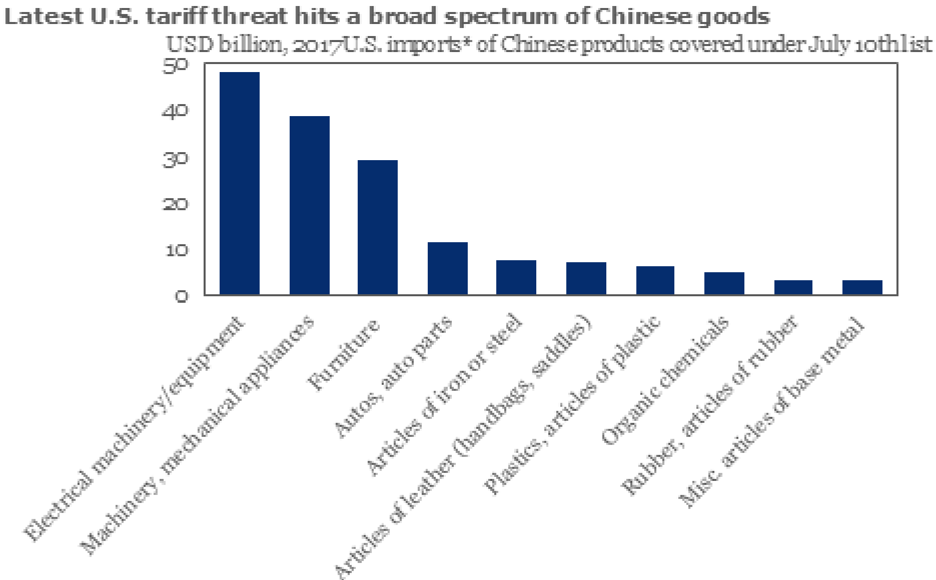
Paper or stop it altogether, and Brussels will certainly insist on further concessions from the UK. Negotiations will continue with the EU leading up to a crucial European Council summit October 18th-19th.

U.S. Sets the Table for Trade Dispute Escalation

First round takes effect. As expected, the U.S. and China moved forward with tariffs last Friday on a collective $68 billion worth of products. The U.S. Trade Representative (USTR) also [published](#) the product exclusion request process for U.S. companies seeking relief from this round of tariffs. The public comment period on U.S. tariffs on $16 billion worth of Chinese products is scheduled for July 24th.

$200 billion more. Late Tuesday, USTR [announced](#) the timeline and product list for proposed 10% tariffs on an additional $200 billion worth of Chinese imports. As with the first round of tariffs, there will be a lengthy public comment period, including 3 days of hearings, ending on August 30th followed by subsequent list revisions and submission to the President for final approval.

What new products is the U.S. targeting? The proposed list of $200 billion worth of Chinese imports includes over 6000 products covering most sectors. The list includes direct consumer products, as well as business inputs. Over half of the products covered (using 2017 import values) are electrical machinery/equipment (o/w a big portion are routers), machinery/mechanical appliances (including circuitry for computers), and various types of furniture. Cell phones and laptops were not on this list.



*Top 10 product groupings shown. Source: USITC, USTR, IIF

Oddly enough, there are near one thousand products that are on the proposed list that the U.S. doesn’t import from China. In some cases (seafood, agricultural products) it appears the Administration took an “everything but the kitchen sink” approach, likely trying to find as many products as possible to add up to the $200 billion target. Other cases, such as the inclusion of LNG or electrical energy, appear to be more symbolic.

Will China retaliate? China announced intentions to retaliate with "necessary counter-measures", but has yet to provide details – they simply do not import enough U.S. goods to stick with their “equal scale and equal strength” strategy. They will likely continue to pursue more "qualitative" measures, such as more scrutiny of U.S. goods at the border, steering contracts away from U.S. corporations, or limiting Chinese tourism to the U.S.

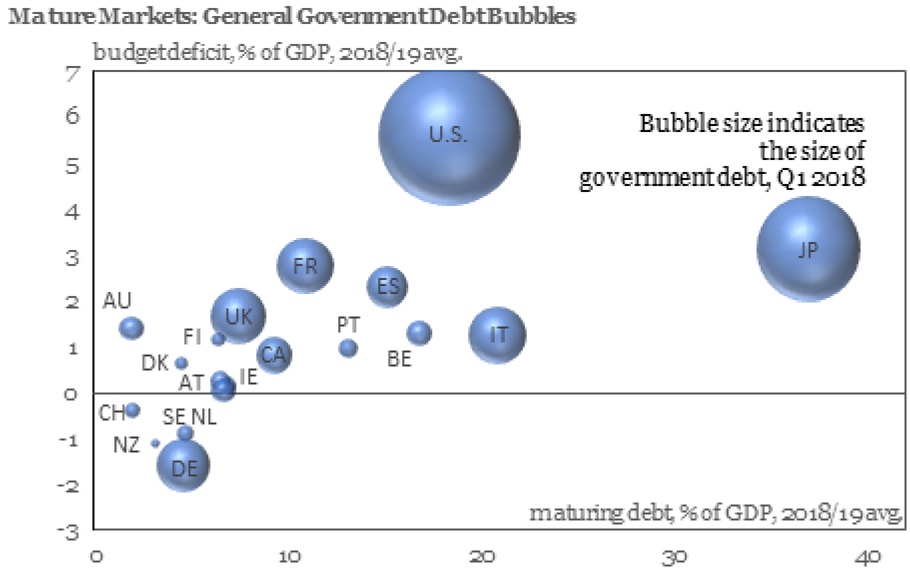
When will this end? Our base case is that this will be a protracted dispute which will not see a durable resolution in the near-term. First, there is no ongoing process to negotiate with the Chinese, and the President hasn't empowered his staff to cut a deal. Second, there is bipartisan support for the President's tougher line against China. Third, now that tariffs are in place, the Chinese will want to be cautious about making quick concessions, which could encourage the Administration to continue to use tariff threats in negotiations with the Chinese.

Global Debt Keeps Climbing

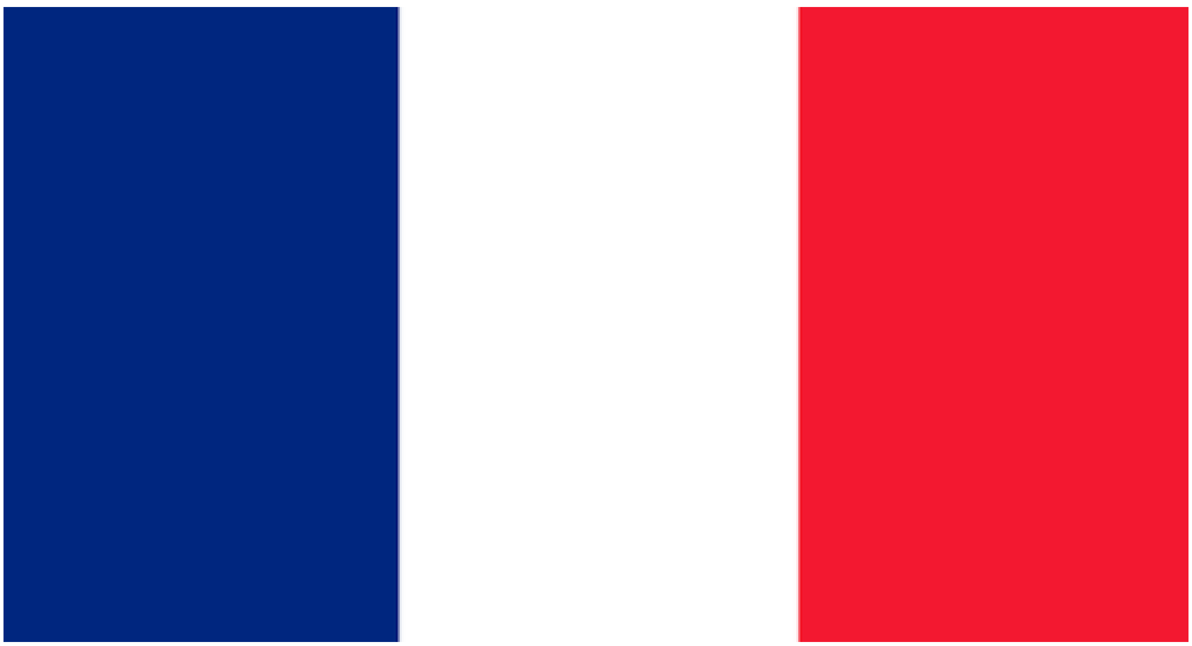
Huge Q1 jump. Our colleague, Emre Tiftik, who leads IIF's Global Debt work, put out a shocking update this week. Global debt – including government, household, and corporate – rose by over $8 trillion in the first quarter of 2018, the largest quarterly jump in 2 years. The global debt-to-GDP ratio, which had been trending lower since 2016 as global growth picked up, rose to 318%.

Debt sustainability concerns. High and rising government debt levels also raise concerns about debt sustainability. This problem may become even more acute going forward as aging populations continue to add to government debt burdens. This leaves the U.S., for example, increasingly dependent on foreign flows to finance its deficit (See Chart 2 from the Global Debt Monitor). For emerging markets, a record $5.5 trillion in foreign currency debt will be even harder to pay back if global rates and the U.S. dollar head higher.

Government debt mounting. It's worth reading the update in full, but one of the points that jumps out is the surge in government debt, particularly in some wealthier countries like the U.S. and Australia. In the U.S., annual budget deficits are rising, notwithstanding solid economic growth, and are expected to keep growing over time. The Congressional Budget Office (CBO) estimates that by 2048, the annual deficit will be 9.5 percent of GDP, even if recent tax cuts are allowed to expire. Moreover, high government financing needs in the future are expected to add to the government debt burden while posing upward pressure on interest rates. With no signs of slowing, sustainability of U.S. debt is likely to be a key vulnerability for some time to come.



Source: IIF, IMF



Macron Marches On

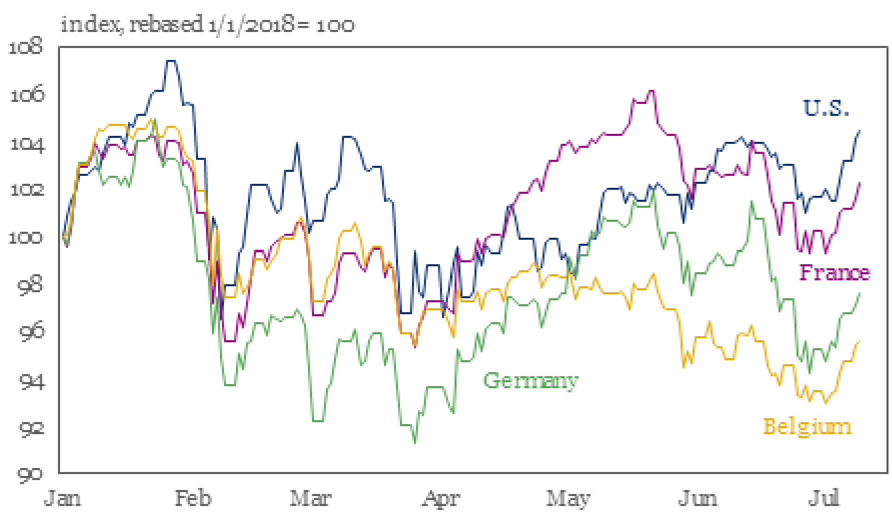
Solid numbers, but low approval. As France heads to the finals of the World Cup, President Macron can look back on his first fourteen months in office with some pride. Economic growth should continue at a solid pace of around 2% in 2018-19; business sentiment remains upbeat; taxes have been cut; and sweeping, market-friendly structural reforms—including to France's inflexible labor laws—have been full speed ahead. Budget deficits are below the 3% threshold, and even the troublesome social security deficit has declined to its lowest level in 15 years. Yet the President has seen his approval ratings fall this year from over 60% to below 35%, and over 70% of respondents perceive Macron's policies as "unjust." What gives?

A difficult transition. In a nutshell, structural reforms have been painful for many, domestic policies around migration are highly controversial, and Macron himself is often perceived as aloof—a "president for the wealthy." Strikes—including walkouts by rail workers last week—reflect widespread resentment of the government's reform efforts and frustration with an unemployment rate that is still above 9%. Finding a balance on migration remains a challenge: the launch this year of a new law to streamline processing of asylum applications (but with tough penalties for undocumented immigrants) has been unpopular with the French left—a key support base for Macron.

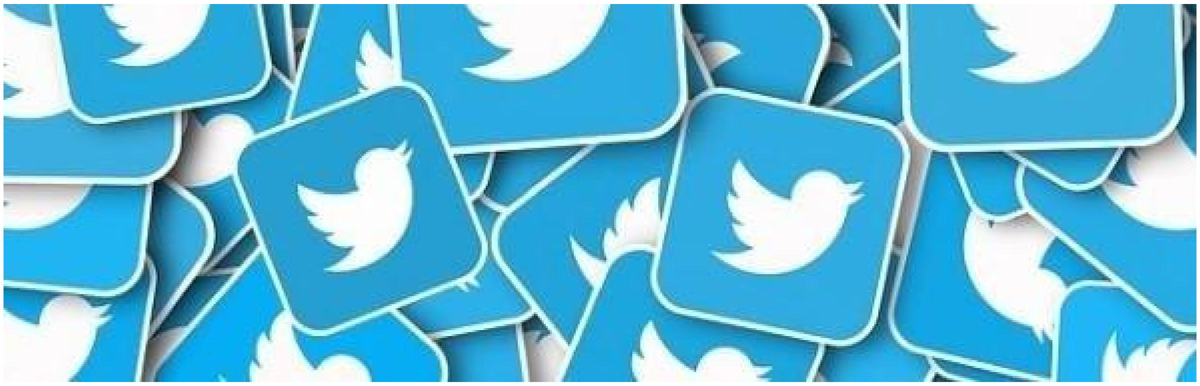
Macron has time on his side—his centrist *En Marche!* Party has a solid majority in Parliament, and the next presidential election is not until April 2022. He looks set to continue to pursue leadership roles within Europe—on climate change, defense, migration policy, WTO reform, EU-China trade and European integration. Signs of success in these initiatives would also provide some domestic political support.

What's better than a World Cup? While Macron faces tough and wide-ranging challenges, he is also getting some votes of confidence—Paris is seeing an influx of finance jobs ahead of Brexit, while the French stock market has been handily outperforming its continental peers this year, rivaling the U.S. In the end, well-calibrated policies and determined efforts on reform could bring much greater rewards than even a World Cup.

French stock market outperforms, too



Source: Bloomberg, IIF



Tweet of the Week: A Race Against Time

Peak Pegasus, a cargo vessel carrying U.S. soybeans, raced against the clock to complete a month-long journey from Seattle to the Chinese port of Dalian before China implemented retaliatory tariffs at noon last Friday.

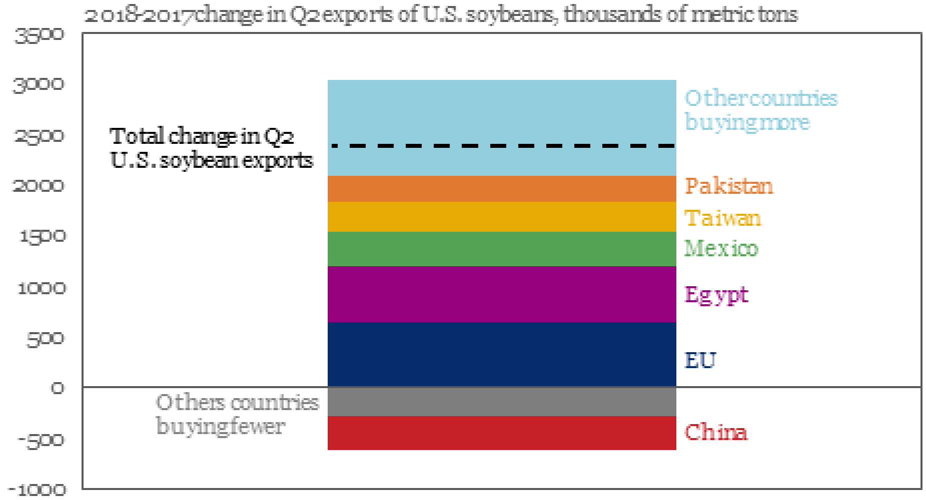
Americans weren't the only ones watching the vessel. According to Reuters, Chinese consumers took to Weibo to offer words of encouragement:

- "Good luck bro!"
- "You are no ordinary soybean!"
- "Poor little soybeans. Try to become a bean sprout, maybe it's not on the tariff list."

Unfortunately, the same Reuters article confirmed that Peak Pegasus missed their deadline - the vessel anchored near Dalian at 5:30 pm on Friday.

Speaking of soybeans, they have also been in the news in the past few days as trade data suggests abnormally large U.S. soybean exports could have an outsized effect (perhaps .3-.6%) on Q2 U.S. GDP growth figures. Weekly USDA data show the U.S. exported 2.4 million metric tons more soybeans in the second quarter compared to last year. As China nearly halted its purchases of U.S. soybeans and bought more from Brazil, other buyers shifted to U.S. soybeans. The U.S. sent over 300 thousand metric tons more soybeans to the EU (mostly the Netherlands), Egypt, and Mexico compared to the same period last year, while China's purchases were down 330 thousand. However, total exports for the current 2017/2018 marketing year are still 3 million metric tons less than the 2016/2017 year, though that gap was over 5 million at the end of March. China's purchases alone are down 7 million metric tons.

With China buying elsewhere, other countries boost Q2 U.S. soybean purchases



Source: USDA, IIF