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 our readers, so send us your thoughts or questions. You can reach us here.

This week:

- Scott Farnham walks through some of the issues behind potential auto tariffs.
- I look at opportunities for Europe stemming from the U.S. trade agenda.
- Paola Figueroa and Ondrej Schneider provide short updates on Venezuela and Nigeria, respectively.
- Dylan Riddle's Tweet of the Week

Thanks for reading,

Kristen

Auto Tariffs: What to Watch For

The U.S. Department of Commerce will hold a public hearing on the national security implications of automobile and auto parts imports on Thursday (July 19th). The hearing will feature a variety of panelists including domestic auto manufacturers, trade and labor association representatives, and foreign government officials. Currently, the scope of the investigation includes imports of all automobiles and auto parts from all foreign countries – though the Administration seems particularly focused on European imports; the EU's Most Favored Nation tariff is 10% on cars, while the U.S. charges 2.5%.

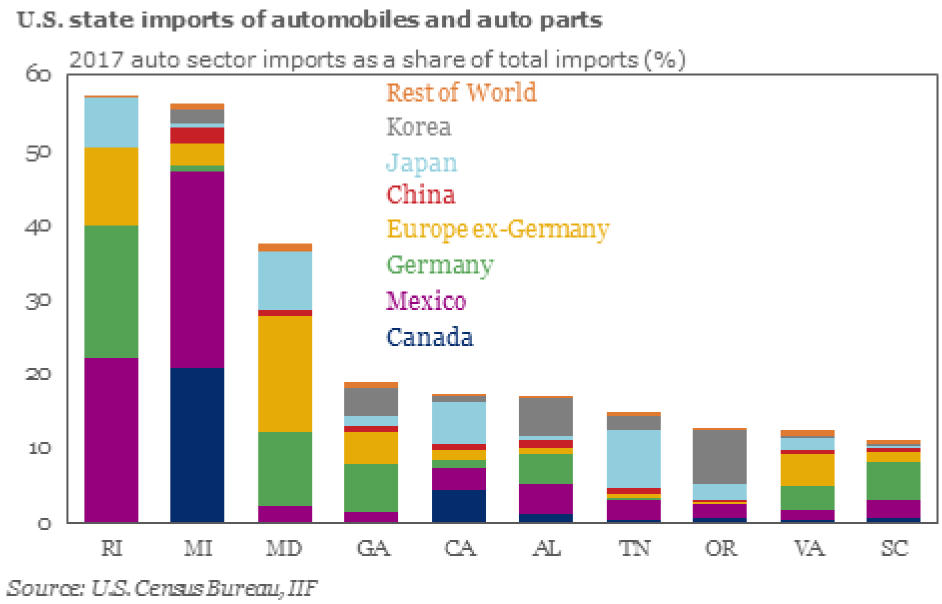
Juncker goes to Washington. European Commission President Juncker arrives in Washington on July 25th to discuss trade tensions. Juncker is expected to kick the tires on a possible deal to reduce global auto tariffs with the world's major auto-trading partners. This is a derivative of an idea President Trump floated in May, though it is unclear where he currently stands on the idea. NEC Director Kudlow's seemingly warm reception to the proposed offer and President Trump's cryptic tweet about trade deals "coming to fruition" indicate at least some openness to discussion.

The legal issues. If the Administration opts to impose limitations on auto imports, it would rely, once again, on Section 232 of the Trade Expansion Act of 1962, as amended, which is also the basis for the steel and aluminum tariffs. Section 232 mandates that Commerce consider a number of issues in its investigation including: domestic production needed for national defense requirements; domestic industry's capacity to meet national defense requirements; the impact of foreign competition on specific domestic industries; and *the close relation of national economic welfare to U.S. national security*. In the past, 232 has only been applied to justify import restrictions in cases in which the product is, itself, used for national defense (steel, oil, metal cutting tools). To apply the provision to autos, the Administration would have to significantly broaden its interpretation of the "economic welfare" clause to suggest that any imports that undermine the U.S. economy also impact national security.

Using such an argument would likely lead to domestic litigation and WTO challenges from affected foreign countries, although it's difficult to challenge a President's 232 decision in U.S. courts. More importantly, implementing protective trade measures on these grounds would increase the chances that Congress amends Section 232 to restore its authority over tariffs and rein in the scope of the national security definition. The pressure from Congress is already mounting, with the Senate recently passing a nonbinding motion to limit President Trump's tariff powers in bipartisan fashion, and longest-serving Republican Senator Orrin Hatch throwing his support behind reining in President Trump's authority on tariffs if he moves ahead.

The auto sector is global. Unsurprisingly, Mexico and Canada, alone, account for nearly half of U.S. auto sector imports – thanks to the dynamic supply chains created after NAFTA. As our colleague, Jonathan Fortun, highlighted in a note last year, the interconnectedness of the North American auto sector is extremely high, and the way we interpret auto sector trade flows changes dramatically when factoring in the "value-added" approach to trade data. For these reasons, there is a possibility that imports from Canada and Mexico would be excluded from any potential auto sector tariffs.

This argument is amplified when looking at U.S. state auto sector imports – Michigan, a swing state, is heavily reliant on Canada and Mexico, but less so on other foreign imports. State auto sector import data, presented as a share of total state imports in the chart below, show an interesting picture. States impacted include auto manufacturing hubs (MI, GA, AL, TN, SC) and states with ports that serve as a gateway to the rest of the country. These states would be most impacted by a slowdown in auto trade, while companies and consumers across the country would be on the hook for absorbing the increased costs. The necessary caveat, of course, is that we have a long way to go before any measures are implemented.



Trade: U.S. Scores Own Goal

Short term challenges in Europe. The IMF has downgraded its growth forecast for Europe by a cumulative 0.3 percentage points for this year and next, noting, among other things, trade tensions with the U.S. This underscores the role trade is playing in increasingly desynchronized growth, as highlighted by our economics team back in April.

Longer term, though, we think there is a case to be made that the U.S. use of tariffs to negotiate better trade deals will ultimately accrue to Europe's benefit by creating a huge opening for EU trade negotiators in Asia. Earlier this week, the EU signed a massive trade deal with Japan, the largest trade deal in EU history, which will eliminate about 99 percent of tariffs on Japanese exports to the EU and about 94 percent of tariffs on European exports to Japan. The EU also has agreements pending with Singapore and Vietnam, is negotiating with Indonesia and the Philippines, and recently launched negotiations with Australia and New Zealand. Europe had an aggressive trade agenda in Asia well before President Trump's election, but Trump's trade actions have given further motivation to negotiations between Europe and Asian trading partners.

Is China next? This was particularly evident at the EU-China Summit earlier this week with President Juncker and Premier Li Keqiang, which produced a statement reiterating the parties' commitment to "fostering an open world economy, improving trade and investment liberalisation and facilitation, resisting protectionism and unilateralism, and making globalisation more open, balanced, inclusive, and beneficial to all." The parties also recommitted to work on an investment agreement and pledged to work together on a collective response to steel overcapacity. The EU shares many of the U.S. concerns about Chinese trade policy, but in the context of the growing trade dispute with the U.S. opted to focus instead on opportunities with China.

Is there any silver lining? Martin Wolf's recent column (Donald Trump Creates Chaos With His Tariffs Trade War) struck a chord this week:

"Another thing the rest of the world should do is to strengthen their co-operation. But the most exciting — and risky — thing other high-income countries could do is to take up Mr. Trump's offer of tariff-free trade. Why not at least call his bluff? Who knows? It might even work."

Issues on the Radar

Focus on the remarkable events around President Trump's Europe trip have left little room for attention to the many other crises developing internationally. Two we're watching:

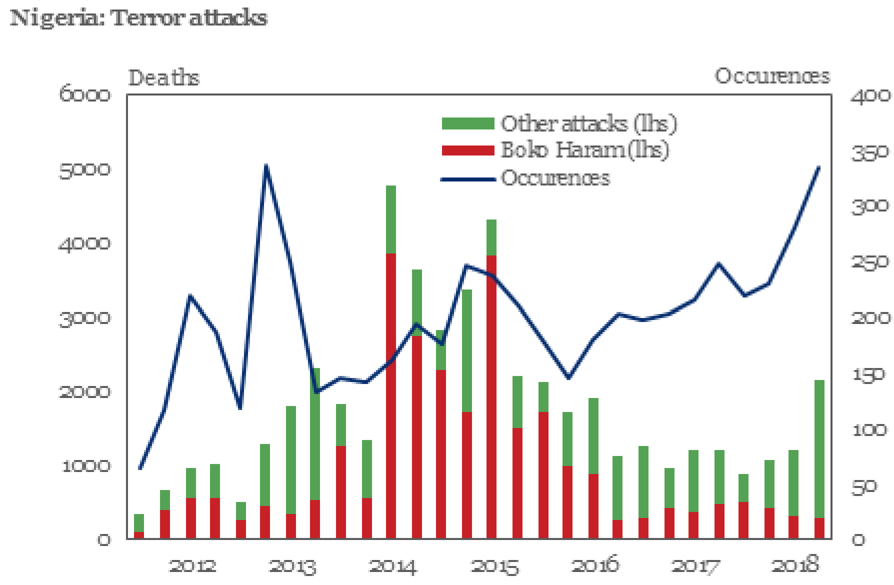
Venezuela. The political and economic crisis in Venezuela has continued to deepen following President Maduro's election on May 20th, which was deemed illegal by the political opposition and the international community. Despite higher global oil prices, the country faces collapsing crude oil production, acute FX shortages, hyperinflation, and increased failures in public services. Finance Minister Simón Zerpa recently announced that the China Development Bank will invest $250 million to increase heavy oil production in Venezuela, while a larger $5 billion credit for direct investment in oil projects is reportedly being discussed with Chinese authorities. However, with already heavy debt repayments due to past loans, increased oil shipments required to service debts, and operational shortcomings of the state-owned oil company, PDVSA, the decline in Venezuela's oil production is likely to continue.

In the face of the crisis, the Maduro regime has continued to consolidate power. In addition to a recent cabinet reshuffle, the National Constituent Assembly, largely controlled by the executive, has appointed Diosdado Cabello, a hardliner Chavista, as its president – a move by the government to withstand threats stemming from mounting international pressure and the rapidly deteriorating economy. With a much-weakened political opposition, steps could be taken to modify the Constitution, aiming to pave the way for Chavismo's permanence in power.

The U.S. has been relatively quiet since Amb. Haley's May remarks and tweet calling for regime change. Though we expect continued designations of government officials, we have not seen movement on another major Executive Order. More recently, the EU imposed sanctions on 11 additional senior Venezuelan officials at the end of June. There is no sign of a resolution in any direction.

Nigeria. The security situation in Nigeria has worsened in Q2 2018, with the number of reported deaths rising to more than 2,100, the highest since 2015 when Boko Haram terrorized northern regions. Violence this time is concentrated in the "Middle Belt," an agricultural area populated by an ethnically and religiously diverse population.

More frequent and deadly attacks have exacerbated food inflation, as food prices increased 1.3% in May. Violence also contributed to a split in the governing APC Party and the forming of a new 39-party alliance (Coalition of United Political Party) that aims to defeat President Buhari in the election scheduled for February 2019. The economy is, not surprisingly, suffering as well. Real GDP growth was low already in Q1 2018 at 0.1% q/q as declining agriculture production – hampered by the violence and an early arrival of a rainy season – offset a robust oil and gas production increase.



Source: Council on Foreign Relations, IIF

Tweet of the Week: Lies, Damned Lies, and Statistics

By now you've seen that Starbucks has decided to phase out plastic straws, which contribute to environmental waste. Many articles on the story noted that Americans use 500 million plastic straws a day. As it turns out, that stat comes from the research of Milo Cress, who arrived at the figure after conducting a series of phone interviews with straw manufacturers when he was nine years old.

While we don't know if Milo is right or wrong (and nonetheless await his application to intern with the IIF research team), the story reminds us to take internet facts with a grain of salt.