STICKY NOTES BY THE IIF

Thank you for joining us for another edition of 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, we share takeaways from the 2018 IIF China Financial Summit
- Latin America Economist Martin Castellano recaps AMLO's win in Mexico, and we reflect more broadly on the market reaction to recent elections
- See Dylan Riddle's Tweet of the Week
- Finally, Scott Farnham follows up on the localized impact of recent U.S. trade actions

Thanks for reading,

Kristen

Takeaways from the 2018 IIF China Financial Summit

IIF Chief Economist for China, Gene Ma, organized an excellent event in Beijing last week. Videos will be available next week here.

A number of discussions at the meeting and in private conversations on the sidelines focused on the U.S.-China trade dispute. The Trump Administration seems primed to move ahead Friday with promised 25% tariffs on Chinese imports, targeted at products central to the Made in China 2025 strategy. As we’ve mentioned, so far the U.S.-China tit-for-tat has been noisy, but relatively modest in terms of economic impact. However, we’re watching some related developments closely:

Recent RMB moves. First, participants in Beijing debated whether we are entering a new stage in the trade dispute – retaliatory devaluation of the RMB – or whether we're just seeing the natural reversal of the appreciation seen since mid-2017. Our sense is that it's a little of both. Beijing will not pursue genuine devaluation, which would carry too many risks for China, given that RMB weakness in 2015/6 was associated with widespread market volatility around the world and – at the very least – set in motion capital outflows. We expect PBOC will intervene to prevent any precipitous drop, a point reinforced by Yi Gang's Q & A on the PBOC website this morning. However, the appreciation seen in early 2018 appeared to us to be, at least in part, an effort to build some good will with the U.S. Administration, and it seems to us that China has abandoned that effort.

RMB's recent weakening adds to growing debate...

Source: Haver, IIF

Under the radar activity. Second, there was discussion of the impacts of "soft sanctions" – namely, the chilling effect of the U.S.-China dispute. The buzz in Beijing is that U.S. companies are quietly, but steadily, losing contracts. Likewise, Chinese investment in the U.S. has rapidly declined, mostly because of Chinese deleveraging, though this may also reflect perceptions by Chinese investors and their U.S. attorneys that they can't clear deals through CFIUS review. Even if actual tariffs remain relatively modest, will "soft sanctions" have longer lasting impact?

Digging in. More broadly, contacts in Beijing seemed prepared and sanguine about the prospect of an extended trade dispute, and their ability to outlast U.S. commitment to the cause. They argue that the U.S. is isolated globally, that the Trump Administration trade agenda looks confused, and that Congress is pushing back. More broadly, they note that U.S. consumers like cheap consumer products and that markets are starting to react negatively, both of which raise risks for the Trump Administration politically. While the U.S. economy looks very healthy in the short term, the U.S. is out of policy tools to counter any slowdown and therefore can't risk a genuine trade war, while the Chinese government doesn't stand for elections and is prepared and willing to offer additional monetary and fiscal support to bolster growth.

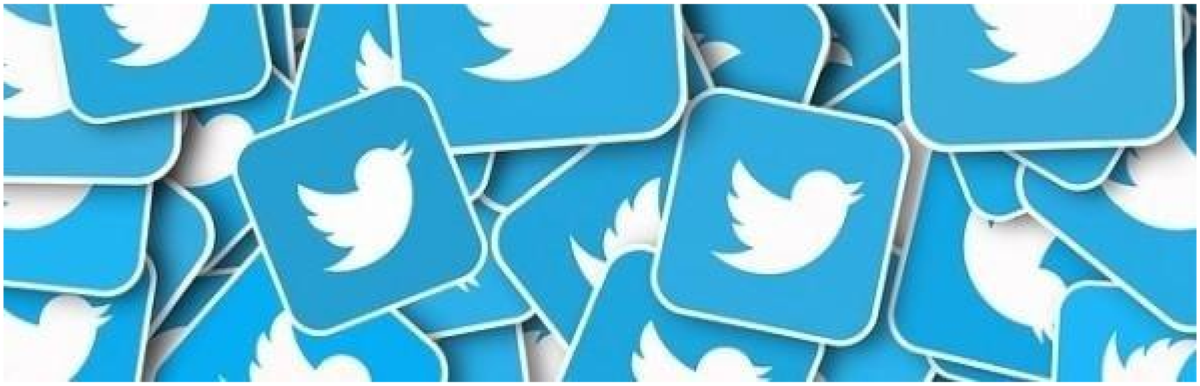
Trump's risk tolerance is high. These are all fair points, though we note that the Trump Administration has a high risk tolerance and genuine commitment to reshaping the U.S.-China trade relationship, and that – unlike the Europe tariffs – the President's China agenda enjoys bipartisan support. Moreover, the impacts of a trade war aren't linear on either side. The impact on the Chinese economy will be modest in the short term, but could dramatically escalate as companies shift supply chains, conditions that will play out in reverse on the U.S. side. For now, the strength of the U.S. economy otherwise is giving the Administration a fair amount of room to be aggressive on trade, and so far we don't see much hedging from the U.S. side.

AMLO's Time

Big challenges ahead. The left-wing candidate, Andrés Manuel Lopez Obrador (AMLO), won the Mexican presidential election with more than 53% of the vote, according to preliminary results. His party, MORENA, also won several governorships, the post of Mexico City mayor, and will likely enjoy an absolute majority in both chambers of Congress. After the election, AMLO moved quickly to reassure investors that he wouldn't make drastic changes to macroeconomic policy. His economic team committed to maintaining an autonomous central bank, a prudent fiscal policy, and the floating exchange rate regime.

Nevertheless, this was a change election in favor of a candidate who supports increased state intervention in the economy, particularly in the energy sector. We expect to see proposals to strengthen public spending, mostly in infrastructure and social programs, though these could be difficult to implement amid fragile public finances, trade tensions with the U.S., and a stronger U.S. dollar. Navigating competing objectives will require pragmatic political leadership. We'll be watching for signs of AMLO's priorities as he takes office December 1.

More generally, our Chief Economist, Robin Brooks, has noted his surprise at the audible sigh of relief from investors following the Mexican and Turkish elections, both of which had outcomes that were at the less market-friendly end of the spectrum. As he noted in a recent tweet, a frequent comment we hear is that "election uncertainty is now out of the way," with the assumption that this is positive. This might be an indication of how difficult H1 has been for markets, with many investors now hoping for a quiet summer lull. In the fall, we may see a resumption of market bumps, with the potential for an Italian budget confrontation with the EU, a growing realization of the challenges around the IMF's Argentina program, and German state elections.



Dylan's Tweet of the Week

Speaking of elections, [see Bruce Mehlman's tweet] yesterday (image above) showing all of the "change" elections in the world over the past few years. Who's next???

U.S. Trade Actions Hit Home

Finally, more on the localized impacts of retaliatory tariffs against U.S. states and sectors, which we discussed last week (you can find an archived version here). The U.S. Chamber of Commerce published a similar analysis yesterday showing the impacts on states. As we await U.S. tariffs against China on Friday (an 80% probability event) and public hearings later this month on national security effects of auto imports and additional tariffs on Chinese products, here are some goods reads on the real-world impacts of the trade dispute:

- Alabama Sees Factory Investments Stall in Midst of Trump Trade Threats (Bloomberg)
- Trump Boils Maine Lobstermen (WSJ)
- Already in trouble, Wisconsin dairy farmers are now getting hammered by tariffs (Milwaukee Journal Sentinel)
- Harley-Davidson Workers Back Trump Despite Jobs Shift (FT)
- In Louisiana, Trump's Trade War Spooks America's Biggest Port (Bloomberg)
- Trump's tariffs will have 'ripple impact' on Tennessee auto sector (Tennessean)
- This Ohio factory thought it could bring U.S. jobs back from China. Then Trump got involved (Washington Post)

- Tariffs rattle South Carolina's manufacturing supply chain (Greenville News)