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:

- I look at the possibility of further sanctions on Russia.
- Greer Meisels provides an update on CFIUS reform and investment restrictions in other countries.
- Jonathan Fortun dives into the U.S. arsenal for a currency war.
- Scott Farnham rounds up a hectic week in trade.
- Dylan Riddle's Tweet of the Week

Thanks for reading,

Kristen

(Programming Note: Sticky Notes will be on a 2-week break. Look for our return in mid-August.)

Russia Sanctions Back in the Spotlight

U.S. Secretary of State Pompeo was in the hot seat Wednesday in the Senate Foreign Relations Committee (SFRC), taking a number of questions on President Trump's Helsinki meeting with President Putin. Surprisingly, his testimony included a semi-endorsement of additional Congressional sanctions on Russia. It wasn't a surprise that Secretary Pompeo, one of the Administration's Russia hawks, supports additional sanctions; it was a surprise he was willing to say so publicly.

The SFRC and the Senate Banking Committee have promised hearings on Russia in the fall, and Secretary Pompeo's testimony increases the odds the Senate will move legislation before the mid-terms. In the Senate, there are two principal drafts which will serve as a starting point for the debate:

- A bill, which has not yet been introduced, by Senators Graham and Menendez, which would impose sanctions on the Russian energy and financial sectors, Russian oligarchs and parastatal entities, and Russian sovereign debt, among other things.
- The "Deter Act," sponsored by Senators Rubio and Van Hollen, which would impose mandatory sanctions if the Director of National Intelligence ("DNI") certifies that Russia has meddled in the mid-term elections.

Pompeo's testimony suggests the White House will not push back hard against Russia sanctions. Even if they support legislation, we expect the Administration to continue to oppose sanctions on Russian sovereign debt, 30 percent of which is held by foreign investors, predominantly in the U.S. and EU. Treasury has said previously that "the effects of the sanctions would not be limited to Russian authorities and businesses. In particular, expanding

sanctions could hinder the competitiveness of large U.S. asset managers and potentially have negative spillover effects into global financial markets and businesses." Our base case is that the Administration's view on this provision will prevail, but it's far from certain.

If sanctions legislation receives a strong vote in the Senate, it may compel the House to vote as well, though – at the moment – House members are reluctant to be seen to be rebuking the President just before the mid-terms. Existing proposals in the House, which are listed below, cover everything from election interference, to Nord Stream 2, to implementation of the Minsk Accords.

Markets seem reluctant to make any definitive judgment on expectations. The ruble strengthened a bit against the dollar during Pompeo's testimony, but the dollar was falling at that time, largely a reflection of the Juncker-Trump announcement.

Russia Sanctions-Related Proposals in the House
H.R. 5576 – Cyber Deterrence and Response Act of 2018
H.R. 5428 – Stand with UK against Russia Violations Act
H.R. 6423 – Punishing Continued Occupation of Ukraine Act
H.R. 6219 – Georgia Support Act
H.R. 6384 – Countering Russian Power Plays Act (related to Nord Stream 2)
H.R. 5910 – Defend Against Russian Disinformation and Aggression Act
H.R. 5216 – DISARM ACT (directs the President to impose sanctions on certain senior foreign political figures and oligarchs in the Russian Federation and certain Russian parastatal entities, and for other purposes)

Enhanced foreign investment screenings, and you don't even have to remove your shoes

Congressional agreement on CFIUS reform. A House-Senate conference

committee reached agreement on reforms to the Committee on Foreign Investment in the United States (CFIUS), the interagency body that reviews inbound investment for impacts on U.S. national security. Changes to CFIUS will be included in the National Defense Authorization Act, H.R. 5515 (115), which is expected to be passed by both houses and to go to the President's desk shortly.

Doing more. The legislation expands CFIUS jurisdiction to cover minority – non-controlling, non-passive – investments, especially those involving critical technology, critical infrastructure, and exposure of sensitive personal data; any change in a foreigner investor's rights regarding a U.S. business; and the purchase, lease, or concession by or to a foreign person of certain real estate in close proximity to military and other sensitive sites. The legislation also sets up an interagency process to identify "emerging and foundational technologies" that should be added to the U.S. export control list. One notable exclusion to the current legislation, due in part to the vociferous objections from U.S. businesses, is that CFIUS jurisdiction **will not** extend to licensing of intellectual property to foreign entities or the establishment of offshore joint ventures.

The legislation becomes effective the earlier of the following two dates – either 18 months after the date of enactment of this act or 30 days after the Secretary of the Treasury determines that regulations, organization, and personnel are in place to administer it. The regulatory process is expected to take a year or more and will involve robust debates about the meaning of "critical technology" and "critical infrastructure" and the question of whether to exclude investments from particular geographies from review – a somewhat more flexible alternative to the previously discussed "white-list" country exemption.

More muscular foreign investment screens are not solely "Made in the USA." The United States is not the only country upgrading its investment screening process – Germany, Japan, France, the EU, and the UK, just to name a few, have recognized the importance of tightening their foreign investment regimes to protect national security. In fact on July 24th, the UK released a new white paper on national security and investment to do just that. The new framework, in addition to encouraging notification of investments, will reserve the right to "call in" transactions, including after they have closed. The UK government's initial analysis expects this to lead to about 200 notifications made each year, about 50 of which may be subjected to an "intervention." To put this in context, between last year and this year there were only two "interventions" made on national security grounds. However, following the release of the white paper, Business Secretary Greg Clark was quick to point out that the UK "… remains unashamedly pro-business and open to high levels of foreign investment in the future." That said, the proposed UK reform (as well as others we have been watching)

points to a growing trend.

Reviewing the United States' Currency War Arsenal

In a July 20th tweet, President Trump accused China and the European Union of "manipulating their currencies and interest rates lower," leading to speculation that the Administration would formally declare China to be a currency manipulator in the next Treasury currency report due in October. In our view, it's more likely the Administration addresses currency issues through alternative measures.

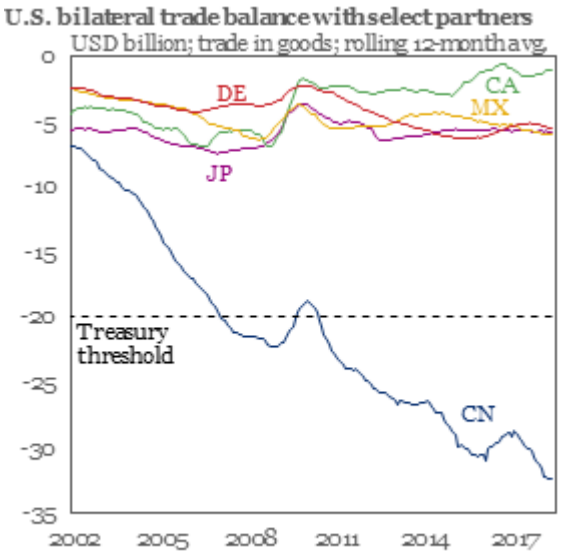
In the Trade Act of 2015, Congress outlined three criteria for declaring a country to be a "currency manipulator": (1) a significant bilateral trade surplus with the U.S., (2) a material current account surplus, and (3) persistent one-sided intervention in the forex market. Treasury subsequently interpreted the criteria to require (1) a trade surplus with the U.S. of over $20 bn, (2) a current account surplus more than 3% of that economy's GDP, and (3) that the country made *repeated* net purchases of foreign currency that amount to over 2% of its GPD in a year. In its last report, published April 2018 , Treasury reaffirmed the criteria and found that no country met all three, although six trading partners were included in a "monitoring list" – China, Japan, Korea, Germany, Switzerland, and India.

If the criteria are met, the Secretary of the Treasury will commence "enhanced bilateral engagement with that country" for one year. If those negotiations are unsuccessful, the country is labelled as a currency manipulator at which point the legislation mandates sanctions against the country including:

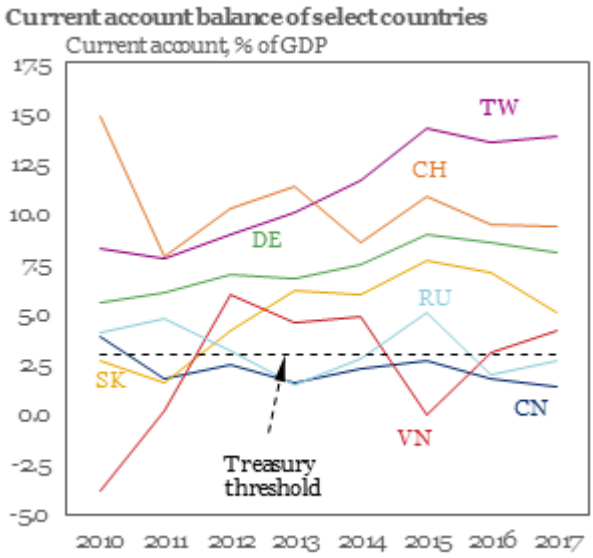
1. Denying access to OPIC financing
2. Excluding the country from U.S. government procurement

3. Calling for heightened IMF surveillance
4. Instructing the U.S. trade representative to take into account failure to adopt appropriate policies in assessing whether to enter into a trade agreement

Although Treasury Secretary Steven Mnuchin has said that his department is closely monitoring China's currency markets for signs of manipulation, we think he's likely to strongly oppose any effort to designate China as a currency manipulator. China, which has a current account surplus of 1.4% of its GDP, is well below Treasury's standard. While Treasury could revise the standard, the sanctions designated by the Act are unlikely to be effective against China in any event, and the one-year negotiating process would not meet the President's objective for immediate action.



Source: US Census Bureau, IIF



Source: Haver, IIF

If the Administration decides to take action on currency issues, we think it's more likely they proceed under an alternative theory:

IEEPA. The Administration could invoke the International Emergency Economic Powers Act (IEEPA), which allows presidents broad powers to impose trade remedies to respond to a national emergency.

Section 122 of the Trade Act of 1974 authorizes the President to deal with "large and serious United States balance-of-payments deficits" by imposing temporary import surcharges not to exceed 15% ad valorem on imported goods, temporary quotas, or some combination of both.

The U.S. Department of Commerce could designate the practice of currency manipulation as an unfair subsidy, allowing the Administration to impose countervailing duties. Under WTO rules and U.S. law, unfair subsidies must provide a benefit with "specificity" (meaning specific to companies, industries or regions). In 2010, the Commerce Department determined that

Chinese currency practices were not sufficiently specific because they apply equally to all parts of the Chinese economy.

Section 301 of the Trade Act of 1974 gives the United States Trade Representative (USTR), an office within the Executive Branch, indefinite authority to respond to other countries' "unfair trade practice," including currency manipulation and market access restrictions, by imposing new duties or establishing new trade barriers.

Counter-interventions. It's unlikely, but because the RMB is now an SDR currency and China's bond market is technically completely open to foreign sovereign investors, there is now no technical barrier for the U.S. to purchase RMB and intervene in the USDCNY market.

Key Week for Trade

Trump the dealmaker. President Trump and European Commission President Juncker announced Wednesday that the U.S. would hold off on further tariffs on EU products as the two sides work to strengthen the trade relationship. As part of the announcement, Juncker committed the EU to buy more U.S. soybeans and LNG. Interestingly, as we showed two weeks ago, the EU had *already* been buying more U.S. soybean as China sources from elsewhere. Juncker and Trump also announced that they will work together to reform the WTO, particularly relating to intellectual property rights and technology transfers – a sign of unity against China, though China was not specifically mentioned in public statements. Along with other loose commitments to improve bilateral trade, they promised to work towards an agreement to eliminate trade barriers on *non-auto* industrial goods. While this could essentially restart negotiations for a scaled-down TTIP agreement, it remains to be seen how much true appetite exists for a broader deal. Nonetheless, the announcement will allow both sides to save face and calm tariff jitters.

What about autos? Commerce Secretary Ross confirmed Thursday that the investigation into national security implications of auto imports will continue, but will hold off on tariff implementation pending the outcome of negotiations. Additionally, there were no announcements around proposals to eliminate existing auto tariffs, and such an agreement would require involvement by most, if not all, of the major auto-trading countries in order to comply with WTO rules. What's more, current tariffs applied under Most Favored Nation rules vary greatly by country and auto product; getting countries to abandon these MFN tariffs will be challenging. If discussions along these lines succeed, it would give companies a green light to amplify their global supply chains, reducing costs through efficiency gains and eliminated border duties. However, we remain skeptical.

Most Favored Nation Average Applied Tariffs to the Auto Sector

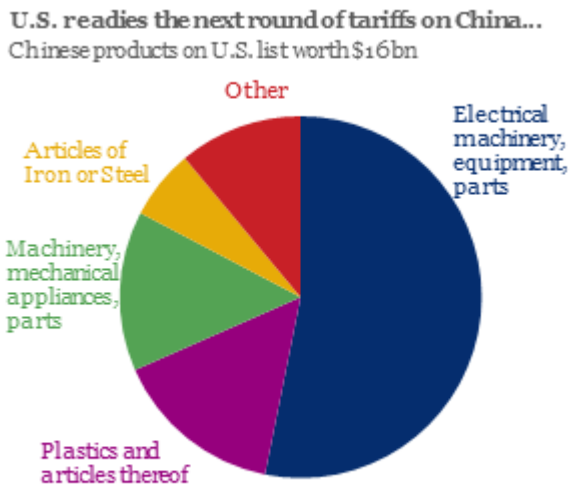
Average applied duties (%)	U.S.	EU	Japan	Korea	Canada	Mexico	China
Cars/passenger vehicles	2.5	10.0	0.0	8.0	6.1	17.5	25.0
Buses/large vans	2.0	12.3	0.0	10.0	6.1	35.0	23.0
Vehicles for transport of goods	23.3	14.1	0.0	10.0	5.6	1.1	21.7
Motorcycles/Mopeds	0.5	6.6	0.0	8.0	0.0	1.4	42.1
Parts/Accessories	1.3	4.1	0.0	8.0	3.3	4.1	10.0

Source: WTO, IIF. Note: Simple averages of product categories used when tariff rates vary.

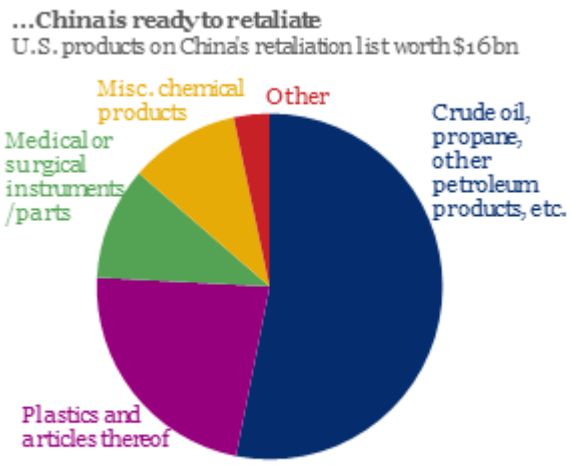
NAFTA meetings resume. After a near two-month hiatus surrounding Mexico's elections, NAFTA negotiators are back in meetings this week. Meetings included a team from Canada in Mexico City earlier this week and a Mexican delegation – featuring the incoming government's NAFTA negotiator, Jesus Seade – in Washington to meet with USTR Lighthizer on Thursday. Chatter surrounding the meetings has taken a more optimistic turn lately, particularly after news that President Trump and President-Elect AMLO support a deal by the end of August. We are skeptical. Disagreements over rules of origin, the U.S. proposed sunset clause, and revisions to the Chapter 19 dispute settlement mechanism remain, with progress difficult to find. Any NAFTA deal at this point would be subject to a vote in the U.S. in the next Congress.

Public Hearings in Washington. USTR held two days of public hearings this week as it readies additional tariffs on Chinese imports worth $16 billion. Panelists were broadly against the implementation of further tariffs, citing difficulty absorbing the 25% duty along with uncertainty over the consumer response to higher prices. The comment period ends on July 31st, followed by further review, possible revision of included products, and submission to the President for his decision. The products included in this round are mainly business inputs such as machinery, plastic hoses, and electrical parts – including many components used in the semiconductor industry. China previously announced a retaliatory product list of the same amount, notably

targeting U.S. crude oil and medical supplies, among others.



Source: USTR, USITC, IIF



Source: MOFCOM, USITC, IIF

Tweet of the Week

Thomas Lee, Co-founder Fundstrat Global, points out that tariffs might not be Harley-Davidson's only problem. On the brightside, if this trend holds millenials will finally have the chance to save an industry instead of killing it.

Thomas Lee @fundstrat · Jul 24

Replying to @TheStalwart

Motorcycle demand skips "generations"... see below