Sticky Notes is back today, after a three-week break. Unlike most years, when activity in Washington slows to a trickle in August, this year turmoil and commotion in Washington continued unabated.

Since we last published, among others: the U.S. Senate passed CFIUS reform and allowed President Trump to override Department of Justice sanctions against ZTE; the U.S.-China trade dispute escalated; the U.S.-Turkey relationship reached a new low as the U.S. imposed sanctions for the detention of Pastor Andrew Brunson and implemented higher steel tariffs; the U.S. reimposed the first round of Iran sanctions, followed by an EU decision to provide Iran financial aid; the U.S. also announced new Russia sanctions, while bills were introduced in Congress to sanction Russian sovereign debt; NAFTA talks with Mexico continued, with progress around auto rules of origin; the U.S. and Japan held trade talks in DC, focused on strengthening the relationship and averting tariffs on Japan autos; and the U.S. subsequently announced that it would push back the timeline for a decision on auto tariffs. And that's not even getting into the latest legal developments.

This week:

- Scott Farnham provides an update on NAFTA negotiations.

- I provide an update on the U.S.-China discussions.

- Sergi Lanau shares our latest insights on Turkey.

- Sonja Gibbs and Paul Della Guardia remind us to keep our eyes on Italy.

Thanks for reading,

Kristen
We love to hear from our readers, so send us your thoughts or questions. You can reach us here.

**NAFTA: A Deal on the Horizon?**

Although U.S. and Mexican officials have publicly stated that major issues still remain, both sides are working hard to firm up differences before the end of August so there is enough time for outgoing Mexican President Enrique Peña Nieto to sign the agreement before he leaves office on December 1st. President Trump has expressed a more positive tone about the negotiations with Mexico, but has also insisted that he is in no rush to finalize a deal. Likewise, Mexico’s Economy Secretary insisted today that it is "better to have a good agreement than a fast agreement," indicating some flexibility in the timeline.

**Auto deal in the works.** It appears a tentative deal between the U.S. and Mexico could be announced within the next week after a busy month of bilateral negotiations centered on rules of origin and wage requirements in the auto sector, as well as the Chapter 19 dispute settlement section. The latest information out of discussions indicates the most recent proposal on auto rules of origin will require 70% (vs. 62.5% currently, but less than the 85% originally proposed by the U.S.) of an automobile’s value to be made in North America – in addition to around 40% from locations paying at least a $16 per hour wage – in order to qualify for zero tariffs. Mexican negotiators have indicated there are still some sticking points, but the latest proposal appears to enjoy support from U.S. auto companies – though foreign auto companies with North American factories have pushed back. Any changes would be implemented after a multi-year phase-in period still under negotiation. The dispute settlement mechanism will remain mostly unchanged, but some sector-specific alterations are being discussed.

**O Canada?** Canadian negotiators – mostly absent from discussions over the past month – are set to come back to the table as soon as the U.S. and Mexico resolve their bilateral issues. While reports suggest Canada loosely agrees with the U.S. negotiating stance on its issues with Mexico, nothing is
set in stone. Canada also has to navigate President Trump’s frequent criticism of its protected dairy industry. Furthermore, all three parties will have to tackle remaining contentious items such as the U.S. proposed sunset clause and changes to government procurement procedures. While a path to a deal looks better than it did a month ago, we expect roadblocks along the way.

**Will Congress go along?** Even with a tentative deal in the next few weeks, NAFTA 2.0 would be subject to a vote in the U.S. in the next Congress – adding further importance to the November midterm elections. Members of Congress have begun expressing concerns about some of the proposals being discussed – labor issues for Democrats and impacts on foreign auto factories in southern states for Republicans. It is still too early to start handicapping Congressional passage, but trade deals are among the hardest fought.

![](image)

**A look at the peso.** The Mexican peso remains a solid barometer of political risk, as we have noted periodically since the 2016 U.S. election. Despite a strengthening U.S. dollar and uneasy appetite for emerging market assets in the wake of the issues in Turkey, the Mexican peso has appreciated markedly since nearly hitting 21 pesos per dollar in mid-June. Reviving our prior model, we see that the actual USD/MXN rate (blue line in chart below) has converged with our model (green line) following the July 1st Mexican Presidential election and as NAFTA discussions appear more optimistic. There is now the narrowest difference between the actual rate and the model since October 2017 with some room for the peso to strengthen if discussions continue in a positive manner. For more on the role of NAFTA on the Mexican economy, please look for an upcoming Economic Views from our colleagues and check out the agenda for our Mexico Economic Forum.
In addition to progress on NAFTA and the positive meeting in July with President Junker, U.S. Trade Representative (USTR) Lighthizer held constructive meetings at the beginning of the month with Japanese Economic Revitalization Minister Toshimitzu Motegi to discuss the economic relationship and the potential to deepen trade between the two countries. There are already talks of a tentative September meeting to continue discussions. Many trade watchers in Washington see signs that the Trump Administration is attempting to “clear the decks” to focus on the trade dispute with China, where there is broader support both within the Administration and in Congress for the President’s policies.

Despite this week’s meetings between Treasury Under Secretary for International Affairs Malpass and Vice Minister Wang Shouwen, we see little sign that the U.S.-China trade dispute will abate anytime soon, as evidenced by the additional tariffs implemented by both sides earlier today. Even within
the Administration, expectations for this week’s meetings were low. At the moment, we think the Trump Administration prefers process over outcome; they aren’t preparing to strike a deal.

**U.S. Actions.** To review, in early July USTR imposed 25% tariffs on $34 billion in Chinese products as part of the case against Chinese IP practices. USTR imposed 25% tariffs on an additional $16 billion in products today. The list of products currently subject to the tariff includes primarily business inputs (machinery, plastic hoses, electrical parts), including components used in the semiconductor industry (despite much protest from the semiconductor industry at public hearings last month).

The Trump Administration is also holding hearings this week on whether to impose tariffs on an **additional $200 billion** in Chinese products. The Administration originally proposed 10% tariffs on the $200 billion, but subsequently announced that it would consider raising the rate to 25%. That public comment period closes September 6th.

**China Responds.** Meanwhile, on July 6th Beijing imposed tariffs on $34 billion in U.S. products including, notably, soybeans, seafood, and auto parts. China has announced that it will retaliate against today’s U.S. tariffs with tariffs on an additional $16 billion in U.S. products. The revised Chinese list excluded U.S. crude oil, but included other fuels such as propane, as well as copper scrap, scrap paper and paperboard, and medical equipment.

On August 3rd, China announced that if the U.S. goes ahead with the tariffs currently under public comment, China will impose tariffs ranging from 5-25% on $60 billion in U.S. products. The Chinese list covers 5000 U.S. products from nearly every export category.

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<tr>
<th>Next Steps in the U.S.-China Trade Dispute</th>
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<tr>
<td>Aug.20-27 USTR hosts public hearings on tariffs targeting additional $200 bn Chinese products</td>
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<tr>
<td>Aug. 23 Implementation of U.S. tariffs on additional $16 bn of Chinese imports; China to retaliate with reciprocal measures on $16 bn US products.</td>
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<tr>
<td>Sept. 6 Public comment period ends for tariffs targeting additional $200 bn. Begins period where USTR can revise product list and submit to President for approval.</td>
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<tr>
<td>Mid-late Sept. Potential implementation of U.S. tariffs on additional $200 bn of Chinese imports; China expected to retaliate with measures on $60 bn U.S. goods.</td>
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*Source: USTR, IIF.*

To sum up, even if both sides stop there, by the end of September we could see U.S. tariffs on nearly $250 billion in Chinese products (about 50% of U.S.
imports from China) and Chinese tariffs on almost $110 billion in U.S. products (nearly 90% of Chinese imports from the U.S.).

Tension in Turkey

We’re continuing to closely watch the sharp fall of the Turkish lira and the escalation of tensions with the U.S. As we’ve discussed, (August 13, August 14, and August 21) Turkey’s reliance on a credit-guarantee scheme to boost growth last year significantly widened the current account deficit, and turned the lira into one of the most expensive currencies in EMs. These underlying problems were exacerbated when the U.S. imposed sanctions on Turkey over the continued detention of Pastor Andrew Brunson. The result? Turkey has seen a sudden stop of capital inflows – needed to sustain the current account deficit – and the lira depreciated rapidly, falling 20% against the U.S. dollar since the end of July.
**What’s next for Turkey?** Following such a sharp depreciation, it’s our view that the lira is now materially undervalued. Going forward, the current account deficit will shrink considerably and may even go into surplus, as depreciation makes imports more expensive and helps exports. However, Turkey has high borrowing needs that will continue to put pressure on foreign reserves. A considerable credit crunch and significantly lower growth lie ahead.

**Spillover effects?** Consensus seems to be that Turkey’s problems will be fairly contained. By itself, it’s unlikely to have major spillover impacts to the global economy, however, the situation may contribute to a broader deterioration of investor sentiment of EMs. Idiosyncratic developments in Turkey may strain markets that are already beginning to feel some of the fallout from higher global interest rates and global trade tensions, by slowing the flow of necessary capital. We’ll be monitoring global capital flows closely through the rest of the year for signs of looming issues.

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**Turkey’s financing needs are sizeable**

USD billion; Turkey’s external financing needs

**Turkey Real GDP Growth and Credit Impulse**

Change y/y (%)  
Change y/y (%)  

Source: Haver, IIF  
*Q3 2018 uses data through Aug. 10th*
Italian sovereign bond spreads have surged again in recent weeks, reflecting market concerns over the government coalition’s current fiscal deliberations. This latest rise follows a sharp spike in May as investors worried that the new government would include supporters of leaving the Euro Area. Despite August’s market turbulence, no other Euro Area country is seeing the kind of bond spread widening that Italy is; although Greece’s borrowing costs remain substantially higher, Greek bond spreads have narrowed by some 50bp since late May in anticipation of the end of its bailout program.

The coalition’s fractious discussions over its first budget – due in October—have centered on fulfilling the League’s and the 5-Star Movement’s respective promises of a business-friendly flat tax and a universal basic income. While cabinet undersecretary Giancarlo Giorgetti has affirmed the government’s commitment to debt reduction, implementing these policies in full could push the deficit well beyond the EU’s 3% Maastricht threshold—perhaps as high as 6-7% of GDP. Furthermore, officials have begun advocating for an €82bn infrastructure spending plan in response to the recent Genoa bridge collapse—a move that could push the deficit higher still. These proposals run counter to EU demands for further deficit reduction in the upcoming budget and will likely weigh on Rome’s relations with Brussels—which have already suffered over the migrant crisis.

Investor concerns center on unsustainability of increased spending and tax cuts, particularly if Italy’s borrowing costs continue to rise. Slow economic growth continues to weigh on revenues, and Italy has the Euro Area’s second-highest government debt burden at close to 150% of GDP. The gap between Italy and the rest of the Euro Area in terms of government debt to GDP is wider than it was pre-crisis. While two-thirds of Italy’s government debt is held by domestic investors (typically less flight-prone than their
foreign counterparts) debt distress would have adverse repercussions for the fragile Italian banking sector. Giorgetti has called for the ECB to continue buying new Italian government bonds in the event of a loss of market confidence; however, ECB plans to wind down quantitative easing make this a challenging ask. Moreover, if credit ratings were downgraded significantly, Italy would no longer be eligible for the ECB’s bond purchase program—and strained relations with Brussels could make it difficult to negotiate support from the European Stability Mechanism.

More broadly, the coalition’s combined fiscal policies would increase recurrent government expenditures while cutting government revenues. While higher spending and tax cuts might boost economic activity in the short run, this hard-to-roll-back policy mix is unlikely to bolster the economy’s productive capacity. Productivity gains could be better achieved via capital expenditures, but Italy’s share of public investment in overall public spending (just over 4.5% in 2017) has been consistently below other Euro Area members (5.8% average in 2017). Moreover, tax cuts for businesses may have a limited effect on growth without difficult structural reforms: in the World Bank’s 2018 Ease of Doing Business report, Italy continues to score poorly in areas such as enforcing contracts, availability of credit, and paying taxes. Against this backdrop, Finance Minister Giovanni Tria—a political novice and former university professor—has his work cut out for him.