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:

- I look at the trade agreement formerly known as NAFTA, and update on the Russia sanctions debate.
- Martin Castellano, Scott Farnham, and Brad Carr provide updates on the situations in Brazil, South Africa, and Australia, respectively.
- Dylan Riddle's Tweet of the Week.

Thanks for reading,

Kristen

The Trade Agreement Formerly Known As NAFTA

During an oddly choreographed Monday press event, President Trump announced a new U.S.-Mexico trade agreement. Although the agreement includes provisions around financial services, digital trade and the environment, and a modified sunset clause, the major provisions focus on

autos, including changes to NAFTA's rules of origin, and dispute settlement procedures. Amb. Lighthizer said that the Trump Administration will notify Congress of the new deal by Friday, allowing the parties to sign – following the statutory 90-day notice period – at the end of November. If the parties are able to reach quick agreement with Canada on outstanding issues, Canada will be added to the agreement, but otherwise the President seemed to indicate that he intends to seek Congressional approval of the bilateral agreement with Mexico and to impose new tariffs on Canada, presumably via the ongoing Section 232 investigation into auto imports.

U.S. Timeline for Renegotiated NAFTA Agreement*

Aug. 31, 2018	Congress notified of intent to sign agreement
Sep. 30, 2018	Release of agreement text
Nov. 29, 2018	Sign agreement
Jan. 28, 2019	List of required changes in law due
Mar. 14, 2019	USITC Report Due
2019 (TBD)	Congressional consideration, implementation

**Assumes notification to Congress on Aug. 31*
***Dates represent minimum statutory periods*
Source: Congressional Research Service, USTR, IIF.

President Pena Nieto, who joined the press event by phone, seemed to have a different understanding, noting the importance of a trilateral arrangement.

Foreign Minister Chrystia Freeland, lead Canadian negotiator, cut her European trip short to start negotiations in DC on Tuesday. Discussion between the U.S. and Canada will focus on two issues:

- The U.S. proposal to remove **Chapter 19 of NAFTA**, which establishes a process of binational panels to review antidumping and countervailing duty matters. Chapter 19 was a redline for Canada in the Canada-U.S. Free Trade Agreement and Canadian negotiators insisted on its inclusion in NAFTA. According to USTR Lighthizer, the U.S.-Mexico agreement eliminates the provision. The Mexican Economy Minister, Ildefonso Guajardo Villarreal, suggested that Mexico accepted the removal of Chapter 19 in exchange for safeguards around steel and the elimination of seasonal tariffs, but that he expects it will continue to be a redline for the Canadians.

- U.S. complaints about the **Canadian agricultural supply-management system**, which regulates supply of dairy, eggs, and poultry products and blocks foreign imports through heavy tariffs—up to 270 percent on dairy products. This is an issue that has preoccupied President Trump, but that poses real political challenges for Canadian negotiators given the importance of the system to Ontario and Quebec, both critical provinces for PM Trudeau's reelection chances. (Indeed, Trudeau's own seat is in Quebec). Ironically, the Harper government

had agreed to undo the system as part of the TPP negotiations, but Canada withdrew the concession following the U.S. withdrawal from the TPP.

Negotiators still have a window, though a narrow one, for resolving Canada-related provisions. Trade Promotion Authority, which allows for expedited review of trade agreements, is only available for trade deals that comply with specified consultation and notice rules. Under TPA, the Administration is required to give Congress 90-days notice prior to signing a new trade deal and must deliver the final text to Congress 60 days prior to signing. If the Administration hopes to sign before President-elect Lopez Obrador ("AMLO") takes office December 1st, 2018, it must present an intent to sign no later than September 2nd and the text to Congress no later than October 2nd. Failing agreement in that timeframe, the Trump Administration would have two options:

1) Continue negotiating with the Canadians, but risk having the agreement with Mexico reopened when AMLO takes office.

2) Move ahead with a bilateral agreement with Mexico to supersede the previous agreement and then withdraw from NAFTA, which would be effective six months later. A number of members of Congress have signaled that they would not support a new NAFTA deal unless it is trilateral. Given the difficulty of trade votes in the best circumstances, this attempt would be high risk. Moreover, there's an underlying legal/procedural issue that would

need to be litigated. Under TPA, the Administration was also required by statute to notify Congress 90 days in advance of opening negotiations on NAFTA revisions. Opponents of the President's approach would argue the Administration provided notice of trilateral negotiations but never provided Congress with notice of intent to negotiate a bilateral U.S.-Mexico deal. This would open the Administration to a resolution in either chamber (particularly if Democrats take the House in November) that the Administration failed to comply with TPA rules and so expedited procedures don't apply. (Indeed, in 2008, Democrats used the Rules Committee to block consideration of trade deals with Colombia, Panama, and South Korea, without cause. TPA gives a lot of leverage to the party holding the gavel).

Russia Sanctions Back in the Spotlight

Hearings in Congress. A number of senior Administration officials testified at Russia hearings last week in the Senate Banking and Foreign Relations Committees, where they attempted to tout the Administration's aggressive approach. Since January 2017, the Administration has sanctioned more than 200 Russian-related individuals and entities for a broad range of conduct including Ukraine, cyber activity, interference in U.S. elections, and support for Syria. The day of the testimony, Treasury announced new designations related to Russian trade with North Korea and for efforts to evade sanctions. With respect to additional Treasury sanctions, Under Secretary for Terrorism and Financial Intelligence Mandelker said that Congress would "without a doubt continue to see more."

With a few exceptions, however, members of the Committees expressed strong dissatisfaction with the efficacy of the Administration's efforts. Most argued for more aggressive enforcement of existing Russia sanctions, and a number explicitly expressed support for new Congressional proposals to tighten sanctions (see the July 26 Sticky Notes).

Treasury Cautions on Debt Sanctions: When asked about possible implications of proposals to sanction Russia sovereign debt, U/S Mandelker referred the committee to a Treasury report, which said that sovereign debt sanctions "could hinder the competitiveness of large U.S. asset managers and potentially have negative spillover effects into global financial markets and businesses." Secretary Mnuchin has reiterated his agreement with that analysis on prior occasions.

Eyes on the Midterms. Earlier today, the Senate Banking Committee announced a September 6th hearing on "*Outside Perspectives on Russia Sanctions: Current Effectiveness and Potential for Next Steps*," which will feature a number of think tank experts likely to advocate for a harder line on Russia. Notwithstanding broad committee support, there are still major obstacles to new Russia sanctions legislation this year including a short legislative calendar and the complexity of the issue. While there is still a possibility of Russia legislation before the mid-terms, our base case continues to be that legislation adopted before the mid-terms would not include sanctions on Russian sovereign debt. However, any testimony by the intelligence community after the election implicating the Russian government in election interference would almost certainly fast-track the full range of proposed Russia sanctions.

Issues on the Radar

Last week, we covered rising risks in Italy and Turkey as a reminder that, notwithstanding turbulence in Washington and rising tensions with Beijing, there are some major, idiosyncratic political events developing in other parts of the world.

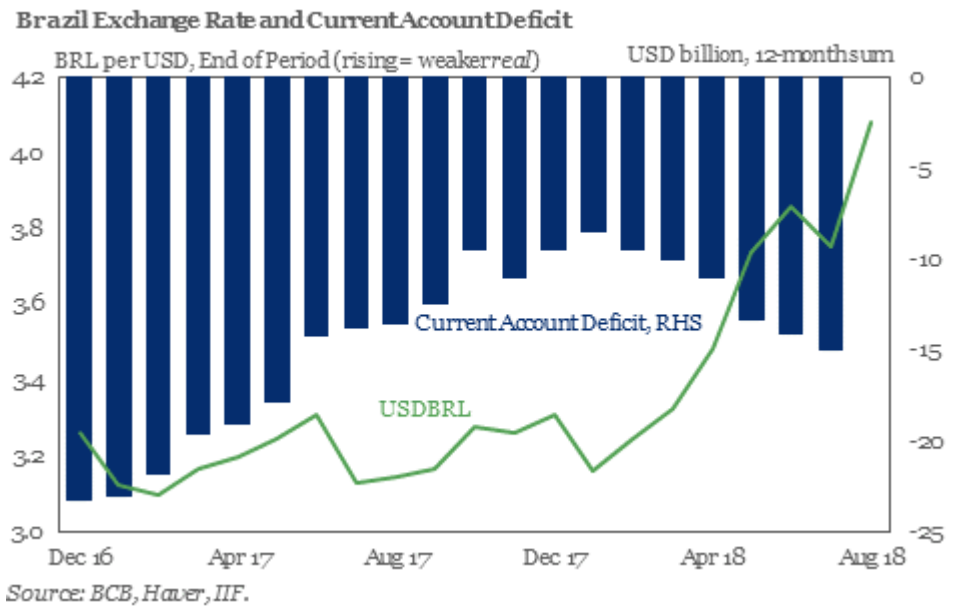
Three more this week:

Brazil: Currency Woes

Several factors have driven the sharp decline in the value of Brazilian assets in recent weeks. While increased global financial volatility has undoubtedly played a role, the real has led losses among EM currencies, reflecting the increased uncertainty surrounding the October 7th general election. The most closely disputed presidential race in decades is taking place in a context of high political fragmentation and heightened public distrust of traditional political parties. Jailed former President Luiz Lula da Silva (left-wing), who will likely be barred from running, remains as the front-runner in most recent polls, followed by Jair Bolsonaro (right-wing), Marina Silva (center-left), and Ciro Gomes (center-left). With more market-friendly candidates lagging, it is far from clear that the next administration will maintain the current policy direction.

The sizable fiscal deficit (7.8% of GDP in 2017) has proven difficult to reduce amid budget rigidities and could drag down growth if not forcefully addressed. Amid weaker-than-expected activity and rising external borrowing costs, prospects that a left-leaning administration, less willing to take politically tough measures to improve the fiscal position, taking office have further fueled investor concerns.

Despite intense downward pressure on the real ahead of the election, Brazil's overall macroeconomic vulnerability is limited as reflected by well-behaved inflation, a small current account deficit (0.7% of GDP) and a large stock of foreign reserves. Moreover, the need to sustain investor confidence, a rules-based fiscal framework and the failure of populist administrations in the past leave a narrow scope for the next government to pursue irresponsible policies.



South Africa: Rand and Land Issues

The South African rand has faced an uphill battle this year, battling external headwinds and domestic political challenges – depreciating 15% against the U.S. dollar year-to-date. Like all emerging markets, South Africa faces a less accommodative monetary policy environment from G-3 central banks, which takes some of the shine off of EM assets for foreign investors. South Africa is also particularly vulnerable to current global developments: the rand is one of the more liquid EM currencies which allows foreign investors to more easily enter and exit positions; a heavy reliance on portfolio (stocks and bonds) investment, which tends to be more volatile, to finance its current account deficit; the highest EM exposure to variable rate international bonds in its corporate sector, making it more vulnerable to rising interest rates; and top export markets of China (10% of exports) and U.S. (7.5%) leaving it exposed to a slowdown in either economy.

On the domestic side, initial excitement for economic reform after President Ramaphosa took office has been deflated after a weak first half of economic data and policy debates over land expropriation without compensation and a new mining charter, among others. In the past month alone, the rand has been hit by multiple headlines on the land issue, Moody's announced concern over fiscal consolidation efforts, and a proposal by the Economic Freedom Fighters (EFF) to nationalize the South African Reserve Bank.

The Land Dispute. Rand depreciation briefly accelerated following President Trump's tweet indicating that he will have Secretary of State Pompeo study a proposal by President Ramaphosa and the African National Congress (ANC), South Africa's ruling party, to amend the constitution to allow land expropriation without compensation – prompted by the desire to raise still-low levels of black ownership of the economy following apartheid – as part of a broader reform package. The idea was introduced at the ANC National

Conference last December, and Ramaphosa announced the constitutional amendment plans on August 1st. On Tuesday, South Africa's parliament withdrew a previously passed bill that would have enabled the state to pay for land and then expropriate it – citing the ongoing effort to amend the constitution as justification, but leaving open the possibility to reintroduce the bill with updated text. A parliamentary committee decision on whether or not to amend the constitution is set to come by the end of September.

Investors have been wary of the proposal, seeing it as a potential overreach of government power which could threaten broader property rights. A hit to foreign and local investment could be on the horizon if expropriation uncertainty hinders business decisions. In fact, despite South African markets stabilizing in recent days, we have seen foreign investor outflows from South African stocks and bonds throughout August while other emerging markets have generally seen inflows. However, Ramaphosa and the ANC received some good news Tuesday as UK Prime Minister May indicated that she supported land reform as long as it is "legal", and committed the UK to more investment in South Africa.

Australia: The Latest Party Room Coup

Since June 2010, Australia has seen 5 changes in Prime Minister, only one of which involved an election and a change of governing party. Intra-party coups are the new normal.

The new leader of the governing conservative coalition, Scott Morrison, who was Treasurer under outgoing PM Turnbull, is unlikely to pursue any major changes in macroeconomic policies, though the party's position on energy policy is an area of some uncertainty. (The mix of coal and renewables in electricity generation had emerged as the major flashpoint between the government's social progressive and reactionary factions, and will loom as Morrison's most immediate challenge.)

The next election is due in early 2019 and looks likely to produce a Labor government. Turnbull was the conservatives' most popular figure, and the latest blood-letting has further tarnished the party's public standing. Moreover, conservatives can no longer trumpet their record of economic management and prudence as the national debt has increased from A$273b to A$531b in the last 5 years.

Tweet of the Week: Branding A Crisis

Kudos to the Wall Street Journal's newest man in Hong Kong, Mike Bird, for a new acronym for this summer's emerging market turmoil: SQUAT

For a more in depth look at things you can read up on the end of gradualism in Argentina, Turkey's outlook, and the risk of contagion.