STICKY NOTES BY THE IIF

Welcome back to 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 by emailing us at stickynotes@iif.com.

This week:

- I report from Mexico City on NAFTA discussions.
- Matt Ekberg updates on the next steps for Brexit.
- Scott Farnham recaps this week's U.S. trade headlines.
- Dylan Riddle's Tweet of the Week.

Thanks for reading,

Kristen

Our Trip to Mexico and Implications for NAFTA

We spent this week in Mexico City at an excellent event organized by Robin Brooks and team and hosted by Banorte. Senior members of the outgoing and incoming Administrations spoke including Secretary Guajardo, incoming Chief de Cabinet Alfonso Romo, and transition team member Arturo Herrera.

On trade issues, I had one major, counterintuitive takeaway. Contrary to most reports, the bilateral U.S.-Mexico deal may be a big win for the Mexican auto industry.

Key Mexican officials confirmed that they have agreement from the U.S. to a binding side letter ensuring that Mexico will be excluded from any further application of Section 232, the U.S. trade provision allowing the President to impose import restrictions based on threats to U.S. national security. As we've discussed here and here, in addition to the existing 232 tariffs on steel and aluminum, the Administration has ongoing 232 investigations into auto imports and uranium. A number of analysts are anticipating auto industry tariffs of between 10% and 25%.

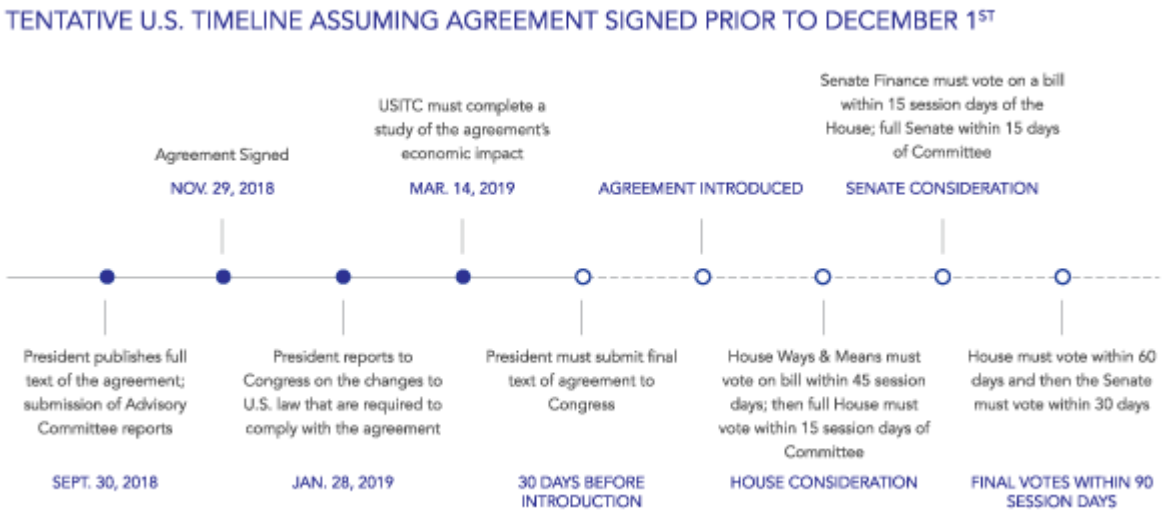
Most reports on the U.S.-Mexico deal that have looked at the new costs imposed by stricter rules of origin, including the labor component, have concluded it will have a negative but relatively modest impact on the Mexican auto sector (see our econ team's view here). There are only three car models made in Mexico that comply with the current rules of origin (62.5%), but would not comply with the new threshold (75%). The rule will have a long phase-in period and non-compliant cars will be subject to the current 2.5% MFN tariff; non-compliant trucks will be subject to a 25% tariff. We don't have sufficient details about the application of the labor component, but it looks to be relatively benign as well.

In the event of any new auto tariffs on Section 232, the side letter would more than offset these costs by shielding Mexico from tariffs, potentially as high as 25%, applicable to other key auto manufacturing countries such as Japan, Germany, and Korea. For example, assuming President Trump uses Section 232 to impose a global tariff of 10%, the side letter would put the overall effective tariff on Mexican cars at less than 0.75%, while other importing competitors would face a rate of 12.5%.

In that sense, the U.S.-Mexico deal may represent a long-term hedge by the Mexicans against protectionist U.S. trade policy. They were willing to take a modest hit on rules of origin in exchange for long-term protection from the large downside risk.

Speaking of NAFTA…

There was a lot of discussion at the meeting about the timeline going forward. Most speakers, and especially Brett House of Scotiabank, were reasonably optimistic that the U.S. and Canada would resolve outstanding issues around the agricultural supply management system and Chapter 19 to allow Canada to join the deal. Whether or not Canada joins the deal, the Administration is expected to submit a text of the agreement by September 30th, triggering a further set of requirements under Trade Promotion Authority.



Importantly, this means that NAFTA 2.0 will be considered in the next Congress, which, according to current polls, may include a Democratic House of Representatives. If Democrats take the House, the chances that the U.S. Congress will approve the new deal drop dramatically. Democrats will be reluctant to give President Trump a big win on one of his major initiatives. Moreover, NAFTA remains deeply unpopular with unions and "fair trade" proponents across the political spectrum, who won't like the renegotiated NAFTA any better – putting pressure on Democrats to avoid a pro-NAFTA vote. Our base case in that scenario is that Democrats in the House will block consideration of Nafta 2.0 until after the next Presidential election.

Brexit Inching Closer

An eventful autumn ahead. With less than 200 days to go before the formal exit of the United Kingdom from the European Union, the parties continued to debate the form of the future relationship. Leaders will meet at the EU Summit in Salzburg on the 19th and 20th of September to discuss the UK's "Chequers" proposal (see our July 12 Note). EU leaders are also expected to announce an extraordinary Brexit summit which will take place in November. The EU's Chief Negotiator, Michel Barnier, has made it clear that he wishes to reach an agreement on the formal withdrawal treaty within six to eight weeks, and reports have indicated that the EU leaders may give additional flexibility to Barnier in terms of securing a deal. Though the contentious issue of the Irish border will likely need resolution at the next leaders' summit in October, the November meeting could bring further clarity on the terms of a political declaration on a future relationship on trade, security, aviation, fisheries, and possibly financial services, among other issues.

The EU continues to insist that the UK does not need a special deal for **financial services access** beyond what other non-EU countries have at the moment. Barnier has stated the EU equivalence regime would be adequate for the post-Brexit relationship, while the UK has proposed a broader equivalence structure with more bilateral dialogue and a treaty-based framework on certain decisions concerning market access.

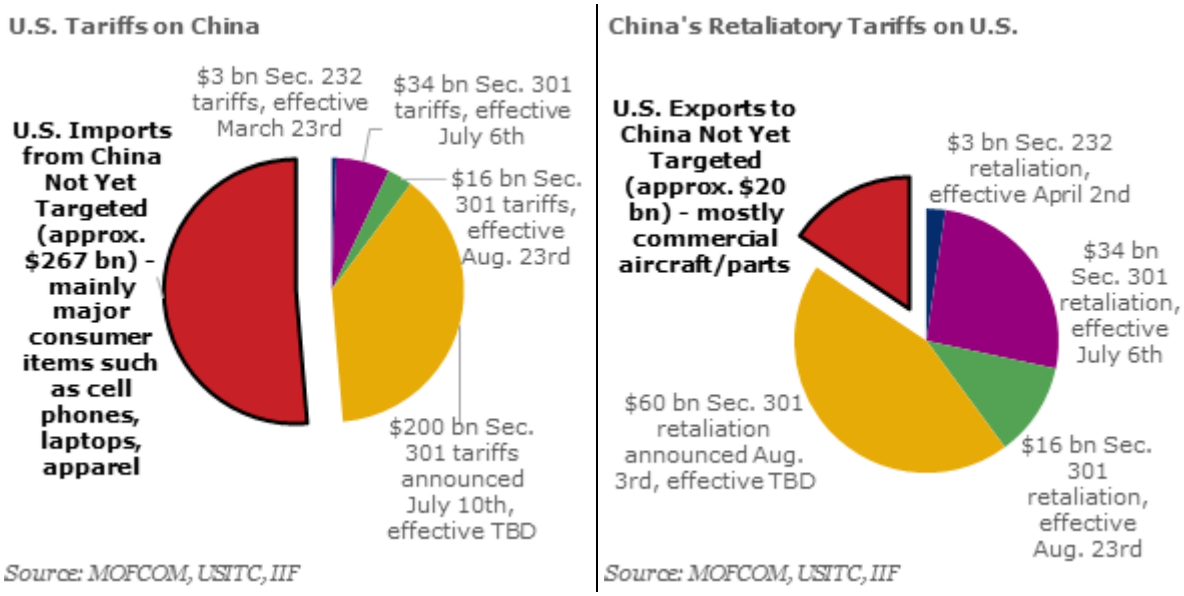
U.S. Trade Roundup: China, EU, and the MTB

Awaiting further tariffs on China. It has been more than a week since the public comment period ended on the next tranche of U.S. tariffs on $200 billion worth of Chinese products, yet no decision has been announced. Earlier this week, it was reported that Treasury Secretary Mnuchin has reached out to his Chinese counterparts to resume negotiations, with some speculation that additional tariffs would be held off until discussions take place. However, the trade hawks in the Administration have argued that tariffs should be imposed regardless of negotiations as it gives the U.S. more leverage.

According to reports on Friday, President Trump has apparently taken the latter view, insisting to impose tariffs despite the effort to reopen discussions – though we await an official announcement. It took USTR nearly one month between the public comment period ending and the decision announcement for the first round of Sec. 301 tariffs, and a week for the second round. Given the scope of this current round of tariffs, a longer review period is unsurprising – particularly given the lengthy public hearings and over 6000 comments received that need to be considered. Our expectation is for implementation of tariffs in some form – the $200 bn worth of products could be revised and/or split up into smaller rounds much like the first $50 bn tranche to incorporate business feedback – around the end of September. China has stated it will retaliate with tariffs on $60 billion worth of U.S. products (see our recap here).

$267 billion more? Separately, President Trump threatened that tariffs on an additional $267 billion worth of Chinese products would be "ready to go on short notice." This appears to be noise at the moment, as USTR has not started the official process – including product lists, hearing dates, comment periods – which is necessary to impose further tariffs using Section 301. $267 billion is nearly all remaining imports from China that have been spared

from the first rounds of tariffs, including politically sensitive key consumer items such as laptops, cell phones, and major apparel groupings. China has nearly run out of U.S. products to retaliate against, with commercial aircraft remaining the elephant in the room. However, China could ramp up "soft sanctions" or raise tariff rates on prior rounds of products as part of its retaliation.



Discussions with the EU. EU Trade Commissioner Malmström and USTR Lighthizer held talks at the beginning of the week in Brussels as part of the "Executive Working Group" initiative stemming from the Trump-Juncker announcement at the end of July. Little of substance came out of the meetings, but reports suggest the U.S. is pushing to first tackle regulatory harmonization and cooperation – discussions that have been ongoing since the prior Administration – before addressing difficult trade issues. The implication is that the U.S. wants the optics of a win on the EU front without tough decisions. However, USTR announced it "will begin consultations with Congress pursuant to Trade Promotion Authority to facilitate negotiations on longer-term outcomes." Real change takes time.

Trump signs Miscellaneous Tariff Bill Act of 2018. On Thursday, President Trump signed the Miscellaneous Tariff Bill Act of 2018, which suspends tariffs on roughly 1700 specified chemicals and other items through the end of 2020. Despite appearing counterproductive to the President's recent trade actions, the bill is mainly administrative, resuming a policy that expired in 2012. Interestingly, the bill includes more than 1100 products in the recently and soon-to-be imposed tariffs on Chinese products – though these products are a drop in the bucket of the total products within scope of the Section 301 tariffs.

Tweet of the Week

Bloomberg's Eddie van der Walt was able to capture the quick rebound in EM currencies following Turkey's rate hike on Thursday:

See previous IIF research for more on Turkey, and what's next for emerging markets.