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 hearing from our readers, so please send us your thoughts or questions by emailing us at stickynotes@iif.com.

This week:

- Scott Farnham updates on this week's U.S.-China trade news, and looks at President Trump's love/hate relationship with big tech.
- Sonja Gibbs and Jadranka Poljak highlight our recent research on debt in developing economies.
- Dylan Riddle's Tweet of the Week.

Thanks for reading,

Kristen

U.S. and China Make it Official

As expected, on Monday the U.S. announced the next round of tariffs on roughly $200 billion worth of Chinese products, which will go into effect on Monday, September 24th at a rate of 10% – rising to 25% in 2019 unless there is progress in negotiations. USTR removed nearly 300 lines from the original list in its revision to exclude a variety of items like smartwatches, bike helmets, and some manufacturing inputs, for a final coverage of 5745 tariff lines. The initial rate of only 10%, as well as the depreciation of China's currency earlier this year, limits the tariff's bite, and the softer approach suggests that the U.S. will get through midterm elections and the holiday shopping season without conspicuous impact on consumer prices.

China confirmed its retaliatory tariffs on $60 billion worth of U.S. products, effective September 24th, covering over 5000 tariff lines – unchanged from the previously released list. Reflecting the lower initial tariff rate imposed by the U.S., China's rate will range from 5%-10% rather than from 5%-25% in the original announcement. Notably, unlike tariffs imposed by the U.S. which become effectively insignificant (at least initially) following RMB depreciation, China's tariffs add an additional hurdle to Chinese importers dealing with adverse currency effects – perhaps a greater incentive to rethink sourcing options (a risk to U.S. exporters).

Subsequently, Bloomberg reported that China plans to lower its most-favored nation (MFN) tariffs on a wide range of goods as early as October. Currently, China's average MFN tariff is 9.8%, but varies greatly by product. The plan serves two purposes: 1. It reiterates their commitment to lower trade barriers in an attempt to "take the high road" during the dispute with the U.S.; 2. It eases some of the pressure on Chinese importers/consumers facing higher tariffs on U.S. products by lowering duties charged on other countries' imports.

Trump warns of more tariffs. In President Trump's tariff announcement, he reiterated his threat of tariffs on the remaining Chinese products, stating "if China takes retaliatory action against our farmers or other industries, we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports." It's important to note that the official USTR statement did not include language on any additional phases of tariffs, nor has USTR made any further official announcements beginning the process. Presumably, the official announcement will come after China's retaliation on September 24th. As we flagged last week, the remaining $267 billion worth of Chinese products not yet targeted by tariffs includes key consumer items such as laptops, cell phones, major apparel groups, and – following their exclusion in the latest round – smartwatches and other small consumer

electronics. Following a similar timeline to the prior rounds of tariffs, implementation would not occur until late this year or early next year.

When will this end? The latest actions by both sides confirm our view of a long, protracted dispute with no clear end in sight. Jack Ma of Alibaba recently warned that the dispute could last decades, though we think it's too early to make those kinds of predictions. In the near term, the longer this goes on, the more U.S. companies and consumers will start feeling the pain as contracts are signed for future shipments reflecting the tariffs – and currency effects eventually wear off.

Trump's Love/Hate Relationship with Big Tech, and Stock Index Reclassification

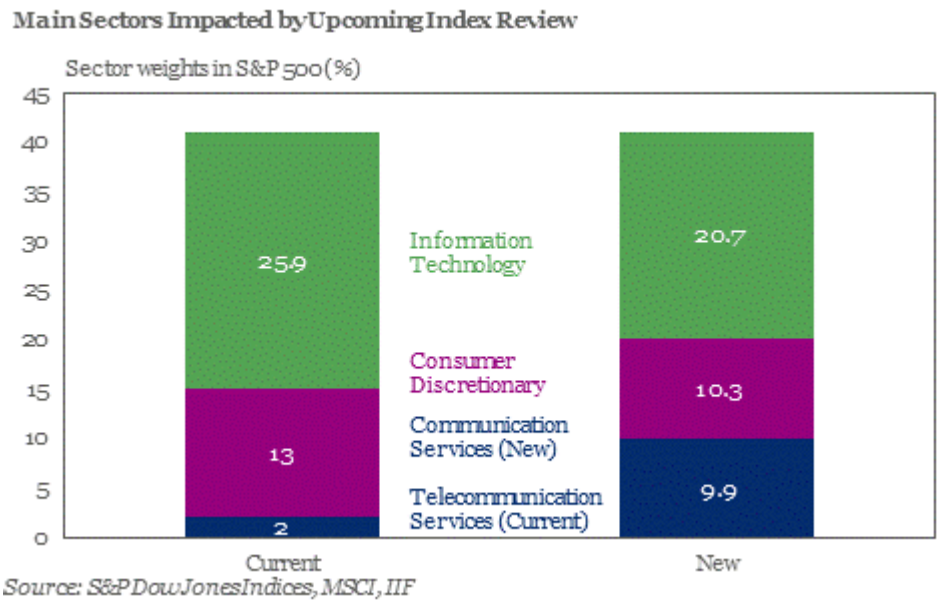
Tech stocks, particularly the "FAANG" (Facebook, Amazon, Apple, Netflix, Google (Alphabet)) stocks, have accounted for over half of the S&P 500's gains this year – driving the index higher even when weakness shows up in other sectors. President Trump likes to cite stock market performance (+10% year-to-date; +40% since 2016 election) as evidence of his policy success, as recently as Thursday morning.

Source: Haver, @RealDonaldTrump, Twitter, IIF

Tech Probe Coming? President Trump also likes to criticize tech companies for prioritizing left-leaning search results or censoring/blocking right-leaning individuals on social media, among other practices. Next Tuesday, state attorneys general will reportedly brief Attorney General Sessions and representatives from the Justice Department's antitrust division on tech firms' practices. Next week's briefing could raise the degree of scrutiny at DOJ of anti-competitive impacts of the big ecommerce and internet platform firms. We believe such a case would be weak under current antitrust principles, but a number of U.S. academics have argued that antitrust law should be reconsidered in light of the enormous market power of these firms. In any event, even the prospect of an antitrust case could drive down tech stocks – and subsequently the broader market, Trump's own success gauge – without the government succeeding in negotiating a major settlement.

Index Reclassification. Separately, tech stocks are in the spotlight for a decidedly less controversial reason: the S&P Dow Jones and MSCI Global Industry Classification Standard (GICS) reshuffle. S&P and MSCI will reclassify the current telecommunications services, consumer discretionary, and information technology sectors starting with S&P indices after markets close today, September 21st, followed by other indices relying on the GICS structure on September 28th, and MSCI index implementation in November. The reclassification highlights the "blurred lines" between different sectors as companies like Apple or Amazon get into different lines of business.

The telecommunication services sector will be expanded and renamed "communication services", gaining major tech companies like Facebook, Netflix, and Google (Alphabet), along with entertainment conglomerates like CBS and Comcast. Notably, investors will to a large extent lose a defensive, high-dividend sector with the inclusion of these more cyclically-sensitive companies. Apple and Microsoft will weigh heavily within the updated information technology sector, while Amazon remains in consumer discretionary. The reclassification is not expected to impact the headline S&P 500 index since overall weightings will remain the same, but sector ETFs used by passive investors and for benchmarks by active funds could see some short-term rebalancing jitters. However, the reclassification was well-communicated, giving index and ETF providers ample time ensure a smooth transition.

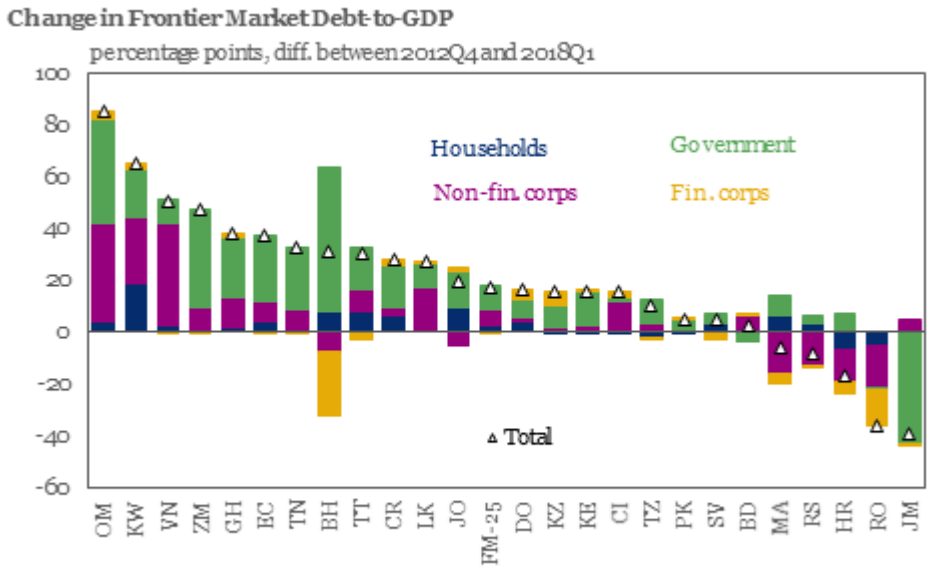


Seeking Clarity: Hidden Debt in Developing Markets

No question about it: after years of borrowing at low interest rates, many of the world's developing economies have accumulated quite a lot of debt. While these capital inflows provide welcome support for economic development and financial market deepening, they can also raise concerns for both policymakers and investors.

Frontier markets offer a case in point: on the back of strong non-resident capital inflows (see our FM Capital Flows Report), total debt has risen $805 billion since 2012, reaching a record high of $2.8 trillion (120% of frontier market GDP) in 2018. Over half of this has been government debt, but the non-financial corporate sector has also raised over $300 billion. Within our frontier market universe, Oman, Kuwait, and Vietnam have seen the biggest increase in debt-to-GDP ratios over this period, while Croatia, Romania, and

Jamaica (which had a second debt restructuring in 2013) recorded the largest declines (see our Frontier Debt Monitor).



Source: IIF estimates, National source, IMF, BIS. Haver.

While these frontier market debt levels aren't nearly as lofty as those reached by their peers in emerging markets (where total debt has reached over 210% of GDP) or mature markets (over 380% of GDP), FM economies have lower capacity to service debt at the current levels. Moreover, as U.S. interest rates continue to rise, there is growing concern that debt service and refinancing may become more difficult for vulnerable borrowers—particularly for hard currency debt, which accounts for over a third of frontier market issuance since 2012. For some countries, it may ultimately prove very challenging to sustain debt at these levels (see our Global Debt Monitor).

Another concern has been the rise in episodes of "hidden" or undisclosed debt. For some countries, including Mozambique and Congo, this has led to sharp upward revisions of government debt ratios—which in turn has led to a loss of market confidence and delays in disbursement of much-needed bilateral and multilateral funding. It seems clear that there are critical "gaps" in disclosure—both in private sector and official bilateral lending—to public sector borrowers in developing markets. This includes lending to state-owned enterprises and other entities that benefit from sovereign guarantees—two areas that can be particularly murky. More broadly, lack of transparency simply makes it harder for both lenders and policymakers to assess debt sustainability.

Solutions aren't easy. Borrowing countries often lack the capacity to collect and monitor debt data for government units outside central administration or to track issuance of government guarantees. In many developing countries there is no clear legal framework for public debt, or the rules may not be properly enforced. On the lender side—outside of public bond markets, where transparency is generally good—borrowing arrangements have become

increasingly more complex and the creditor universe has diversified. Since the cancellation of $100 billion in external debt through HIPC (1996) and MDRI (2005) initiatives, developing countries are increasingly borrowing from private creditors, including through bond markets. Much of the new debt is at non-concessional terms, increasing the debt service burden and reducing the availability of funds for development needs.

New initiatives to increase transparency in sovereign debt markets will help. The G20 and the international financial institutions are working both on capacity building and on guidelines for greater transparency on the part of EM borrowers. The private sector too has initiatives underway, including a set of voluntary principles for debt transparency under development here at the IIF. While the road ahead may be challenging, growing awareness of the problem—threats to debt sustainability, coupled with hidden debt levels in some cases—is an important step towards addressing it.

Tweet of the Week

The "Made in China 2025" initiative is at the center of the U.S.-China trade dispute. As Bloomberg's Peter Martin showed earlier this week, at least one aspect of the policy isn't going as planned.

Peter Martin
@PeterMartin_PCM

Follow

China's Made in China 2025 industrial policies aim to see Chinese firms dominate the domestic market for robots, but - despite generous subsidies - Chinese manufacturers are actually losing market share to more competitive Japanese and European alternatives

11:02 PM - 19 Sep 2018