STICKY NOTES BY THE IIF

Welcome back to Sticky Notes, the IIF's review of topics and events we're watching in international economics and politics.

Please email us at stickynotes@iif.com if you have any topics you want us to address in our "all politics" edition of Sticky Notes ahead of the U.S. midterm elections on November 6th.

This week:

- I look at takeaways from our Annual Meeting in Bali.
- Emre Tiftik updates on Chinese capital flow developments.
- Ondrej Schneider previews the Sub-Saharan Africa election cycle in the first of a two-part series.

Thanks for reading,

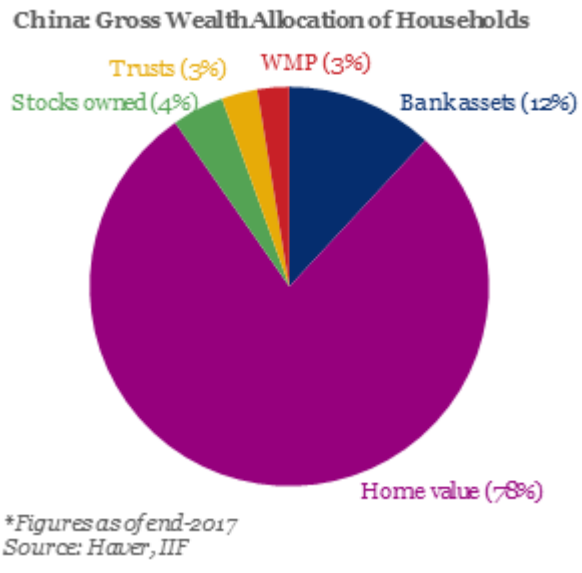
Kristen

U.S.-China Dispute Headlines Bali Meetings

The IIF team is back from our Annual Meeting in Bali, on the margins of the IMF-WB meetings. Videos of our sessions are available here.

Conversations in Bali were focused, not surprisingly, on the U.S.-China trade dispute. A number of speakers expect a trade deal after the midterms, noting that the Chinese have resumed imports of U.S. soybeans and gas and appear to be trying to avoid further escalation. However, most experts endorsed our view that the trade tensions between the U.S. and China will be playing out for some time to come. Among other things, the discussion in Bali highlighted for us the degree to which U.S. and Chinese officials are operating under misconceptions of what it will take to persuade the other party to capitulate.

For example, in his recent Lesley Stahl interview, President Trump cited the fall in the Chinese stock market as evidence that the U.S. tariffs were working to bring pressure to bear on Beijing. He may be overestimating the degree to which market valuations and even economic growth figures will pressure Xi to yield. It's certainly true that the Chinese are concerned with the stock market as a confidence indicator. Vice Premier Liu He and top officials from the PBOC, Securities Regulatory Commission, and Banking and Insurance Regulatory Commission attempted to calm markets with statements about the underlying strength of the economy, the stability of the financial system, and availability of policy tools to support businesses. However, the wealth effect of China's stock market is small in comparison to housing and bank deposits. At the moment, the Chinese attribute weakness in growth more to their own domestic deleveraging plan than to trade.



Likewise, the Chinese seem to be operating under the assumption that President Trump's trade policies are principally designed as a political message to rally voters for the mid-terms and that he'll shift strategies after

the election. We don't view it that way. There is, of course, some domestic political value in Trump's anti-trade/anti-China messaging, but the politics on trade issues are complicated. A number of the most competitive House seats are in agriculture-oriented districts, which have been losing export market share as a result of retaliatory tariffs.

As a pure political play, the U.S.-China trade skirmish is a risky one. We think the President's policies are – fundamentally – a product of the substantive policy views of the President and his Advisors about the long-term threat of China competition, rather than a mid-term election ploy. However, given the President's focus on financial markets as a barometer of success, a significant market disturbance could shift his trade agenda.

Tight Races in Agriculture-Oriented* House Districts

State-District	Current Party Control	Trump 2016 Net Vote %	Real Clear Politics Score
AZ-1	Dem	+1.1	Leans Dem
CA-10	GOP	-3.0	Toss Up
CA-21	GOP	-15.5	Leans GOP
IA-1	GOP	+3.5	Leans Dem
IA-3	GOP	+3.5	Toss Up
IL-13	GOP	+5.5	Leans GOP
KS-2	GOP	+18.4	Toss Up
MI-6	GOP	+8.4	Leans GOP
MI-7	GOP	+17.0	Leans GOP
MN-1	Dem	+14.9	Leans GOP
MN-2	GOP	+1.2	Leans Dem
MN-7	Dem	+30.8	Leans Dem
MN-8	Dem	+15.6	Leans GOP
MT-1	GOP	+20.6	Leans GOP
NC-13	GOP	+9.4	Toss Up
NM-2	GOP	+10.2	Toss Up
NY-27	GOP	+24.5	Leans GOP
PA-10	GOP	+8.9	Leans GOP
WA-5	GOP	+13.1	Leans GOP

**Districts are in top quartile of agricultural production by value*
Source: USDA, Real Clear Politics, IIF

RMB in the Spotlight

One of the key questions coming out of the Bali debate was what all of this means for the RMB. The natural result of additional U.S. tariffs would be further RMB depreciation. Yesterday Robin Brooks and team put out a note analyzing RMB depreciation, which argues that, in the event of U.S. tariffs on the remaining $267 bn in Chinese exports, even a move of the $/CNY above 7.00 – viewed by many as a redline – wouldn't necessarily reflect a competitive devaluation, but would be the natural result of a decline in Chinese fundamentals and normal market-driven exchange rate behavior.

The Trump Administration is very likely, however, to view any further depreciation as grounds for a response. In this week's currency report, the Administration stopped short of officially naming China a currency

manipulator, but devoted an unusually large section to concerns over China's trade surplus and currency behavior. The report's heavy criticism of the RMB depreciation this summer – which happened without any notable government intervention – is at odds with long-term efforts to promote a free-floating Chinese currency as it essentially calls for China to keep the RMB stronger than its market valuation. Similarly, the report explicitly noted that Treasury will start monitoring for "symmetrical" intervention in FX markets and whether countries "resist depreciation pressure in the same manner as appreciation pressure." The addition of the language opens the door for China to be named a currency manipulator in a subsequent report, though it currently fails to meet all three criterion thresholds (see our April 2017 primer on currency manipulation and our short update from July). China, Japan, Germany, India, South Korea, and Switzerland remain on the report's "Monitoring List".

U.S. Treasury Currency Manipulator Evaluation Criteria

	Goods trade surplus w/ U.S. > $20 bn	C/A surplus > 3% of GDP	Net FX purchases > 2% of GDP	Net FX purchases in 8 of past 12 months
China	**390**	**0.5**	**0.0**	**Yes**
Mexico	73	-1.6	0.0	No
Japan	**70**	**4.0**	**0.0**	**No**
Germany	**67**	**8.2**	--	--
Italy	32	2.8	--	--
India	**23**	**-1.9**	**0.2**	**No**
Korea	**21**	**4.6**	**0.3**	**No**
Taiwan	17	14.3	1.2	Yes
Switzerland	**17**	**10.2**	**2.4**	**No**
France	16	-0.6	--	--
Canada	15	-3.1	--	--
UK	-7	-3.5	--	--
Brazil	-9	-0.7	-2.0	No

**Figures are calculated for the 4 quarters ending June 2018*
***Bolded** countries are on the "Monitoring List"*
Source: U.S. Treasury, IIF

Impending Iran Sanctions

Finally, for anyone still in the camp that thinks geopolitical risk will all be resolved soon, it's worth pointing out that Iran sanctions due to be re-imposed November 4th will create another opportunity for heightened tensions. As we've reported previously, the Trump Administration will be re-imposing correspondent banking sanctions, which will severely limit current correspondent banking in the U.S. for any foreign bank, including foreign central banks, that processes payments through Iran's central bank if the transaction at issue is for oil purchases. Exemptions are provided for banks in countries that reduce their Iranian oil purchases, but the Chinese have insisted that they will not reduce oil purchases from Iran.

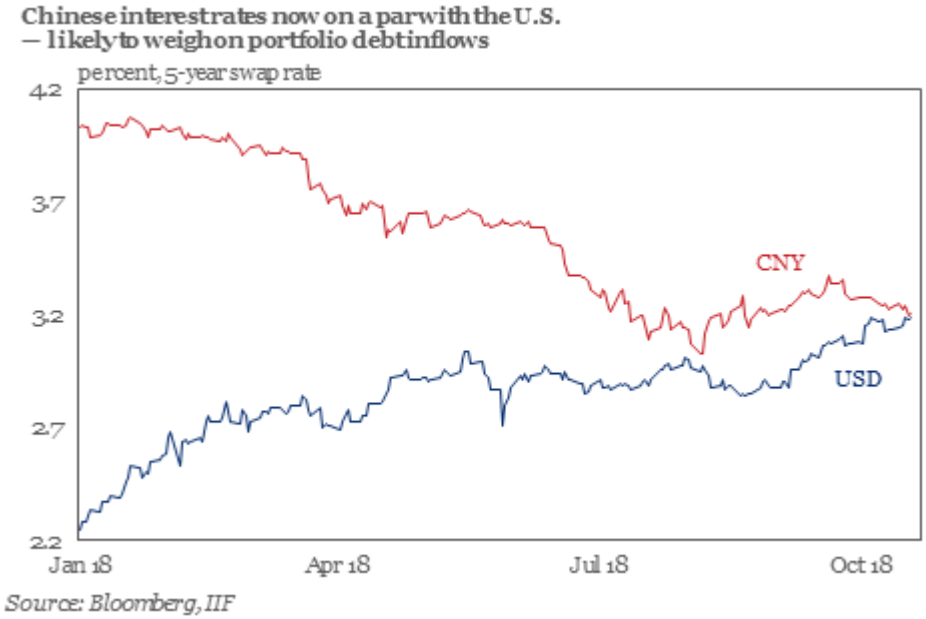
A Brief Update on Chinese Capital Flows

Amid a steep decline in Chinese equities, a weaker RMB and softening economic growth, all eyes are once again turning to Chinese capital flows. The situation looks considerably less dire than in 2015-16, when hefty capital outflows from China reverberated across global financial markets. Indeed, China has engineered a remarkable improve-ment in flow dynamics since then, not least by tightening up on capital controls. Stronger appetite for Chinese stocks and bonds this year—as these markets become more open to foreign investors—has also helped, as noted in our latest report on EM Capital Flows.

Source: IIF

However, the strong pace of inflows through August was hard to reconcile with the poor performance of Chinese stock market and falling Chinese interest rates—typically a deterrent to yield-hungry investors. September has

been something of a wakeup call: with the backdrop becoming more challenging, the narrowing interest rate differential looks to have provoked a sharp slowdown in portfolio flows to China in September, pushing broader net capital flows back into the red and prompting the central bank to intervene in forex markets to support the renminbi for the first time since January 2017.

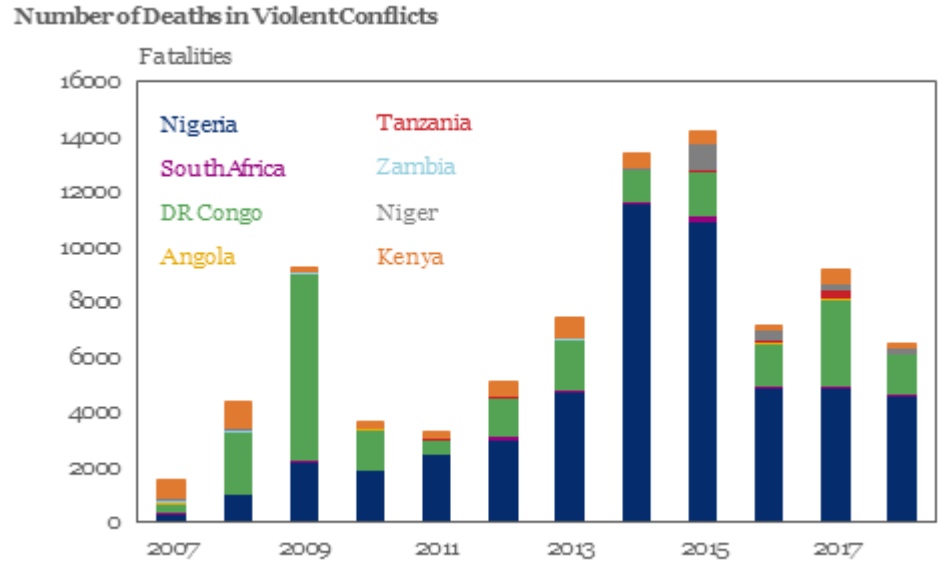


Going forward, China's domestic growth outlook remains key. Efforts to stimulate the economy via expansionary policies should help curb potential resident capital outflows (which were a big problem in 2015-16), while keeping non-resident banking inflows strong. However, stimulus on a large scale could also mean a renewed focus on the risk of China's high debt-to-GDP ratios. Further buildup in private sector leverage could undermine risk sentiment, weighing on foreign appetite for Chinese securities and posing another threat to Chinese capital flows.

Sub-Saharan Africa Election Cycle Shifts into a Higher Gear

Sub-Saharan Africa is at the peak of an election cycle. Recent elections in Angola and Zimbabwe have ended decades of authoritarian rule. The October 7th election in Cameroon likely confirmed another term for President Biya, who has been in office since 1982 (official results expected on October 22nd). But even he has faced a stiffer opposition than in previous elections.

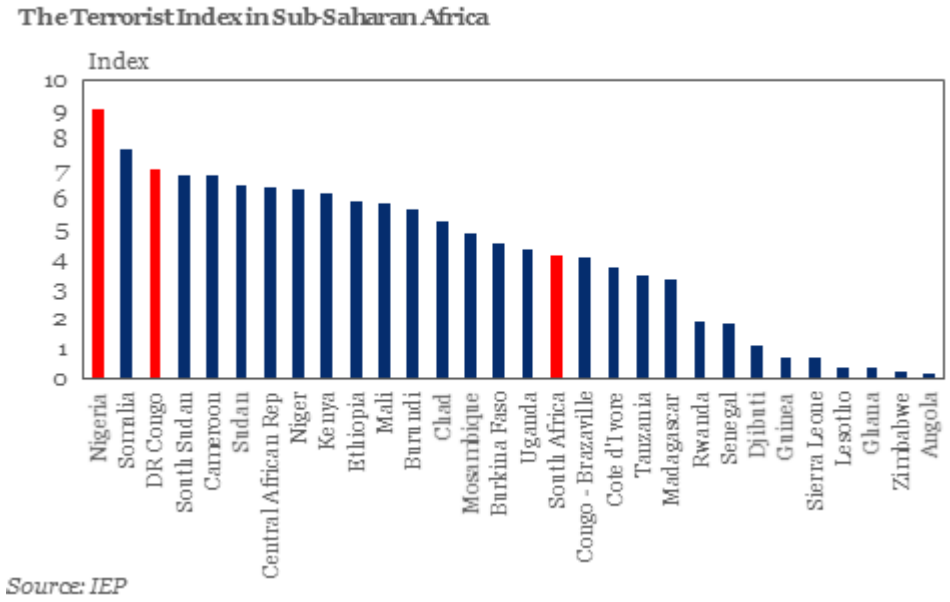
Among the forthcoming elections is the highly anticipated December presidential election in the Congo, which has been delayed for more than two years. In a short sequence after that, South Sudan, Madagascar, Benin, and Senegal will likely hold elections. In February, Nigeria will elect a new president, followed by the South African parliament elections in May. The parliament will subsequently vote for a president. The elections take place amid a high level of politically motivated violence: Boko Haram attacks have claimed almost 30,000 lives in Nigeria since 2012; more than 20,000 people have died in violent clashes in the Democratic Republic of the Congo (DRC) since 2007; and the death toll in South Africa amounts to almost 1,000 since 2007. Moreover, after security improved in 2016, the trend reversed again last year, and the number of fatalities this year runs at a similar rate to 2017.



Source: Haver, IIF

The elections in the three of the most populous sub-Saharan countries – Nigeria (200 million), the Congo (85 million), and South Africa (57 million) – are very different, but they all threaten political stability within already strained nations. The Terrorist Index, assembled by the Institute for Economics and Peace in Sydney, shows an exceptionally high level of terrorist activity in Nigeria and the Congo and only slightly less so in South Africa.

DR Congo. The outgoing president, Kabila, who ruled the Congo for seventeen years, finally agreed to hold the presidential election in December 2018, more than two years after the original date. Poor access to remote regions and ongoing hostility in east regions would make logistics of the election challenging even in more solid conditions, but the government has introduced a new and untested electronic voting system that the opposition fears could be easily rigged. The election result could therefore be disputed and could lead to further escalation of violence in the country.

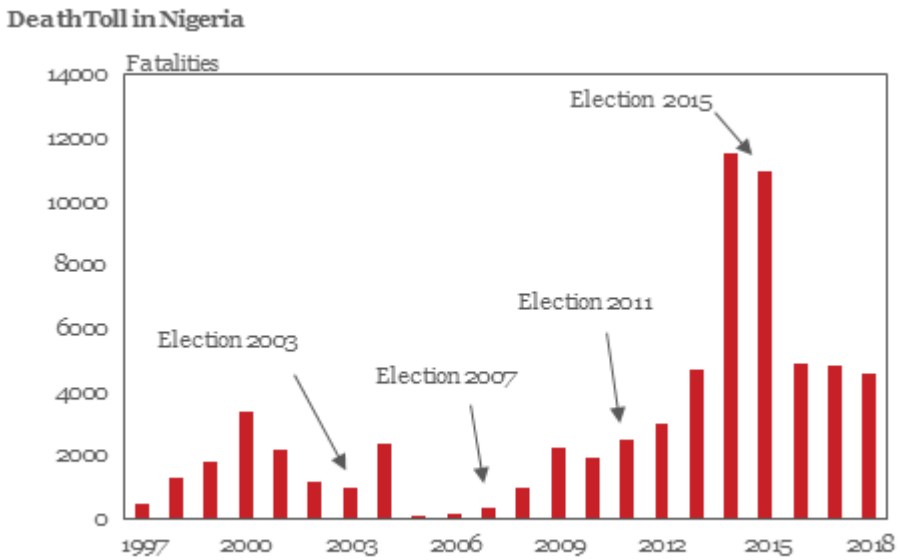


Nigeria has been plagued by terrorism with more than 50,000 deaths since 2008. The death toll peaked in 2014 when 11,500 people died in various terrorist attacks, most of them by Boko Haram, the terrorist group linked to the Islamic State. President Buhari was elected amid the spike in terrorist activities in 2015 on a promise to eliminate terrorism and defeat Boko Haram. However, after halting the death toll in 2016, progress in reducing terrorism has slowed. The economy slid into recession in 2016, which led to a currency crisis and an eventual 50% devaluation of the national currency, the naira. The slow recovery since 2016 and the increasing perception of persisting corruption have led to a split in the governing APC party with several powerful parliamentarians and state governors switching from the APC to the opposition PDP party that governed Nigeria before 2015.

As we argued in our Country Report, Nigeria needs governmental reform to increase investment in human and physical capital and raise the sustainable growth rate from the current 3-4% to the 7-8% that it was achieving before the oil crisis of 2015. The government, however, spends only 0.6% of GDP on investment, and the employment rate is only 60%, with 20% of the adult population unemployed. The current push for tripling the minimum wage (currently at about USD50 per month) could make formal employment more attractive for underemployed workers, but too high of a minimum wage rate

could push low-skilled workers out of the formal labor market, which is opposite of what the country needs.

Next year's election is unlikely to resolve these structural flaws, but it could stabilize public finances (the consolidated government budget was almost 6% of GDP deficit last year), help revitalize the banking sector (credit to the private sector has been shrinking since 2016), and unify the current multiple exchange rate system. These reforms, along with strengthened investment in education could help Nigeria increase the living standard of its 200 million citizens and improve security in a crucial African country.



Source: IEP