Welcome back to 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:

- I look at remaining questions about U.S. Iran sanctions ahead of the November 4th implementation date.
- Sonja Gibbs and Paul Della Guardia update on the contentious situation in Italy.
- Sergi Lanau looks at Brazil in the wake of the presidential election.
- Ondrej Schneider wraps up a two-part series on Sub-Saharan African politics.
- Scott Farnham updates on German politics.
- Dylan Riddle's Tweet of the Week.

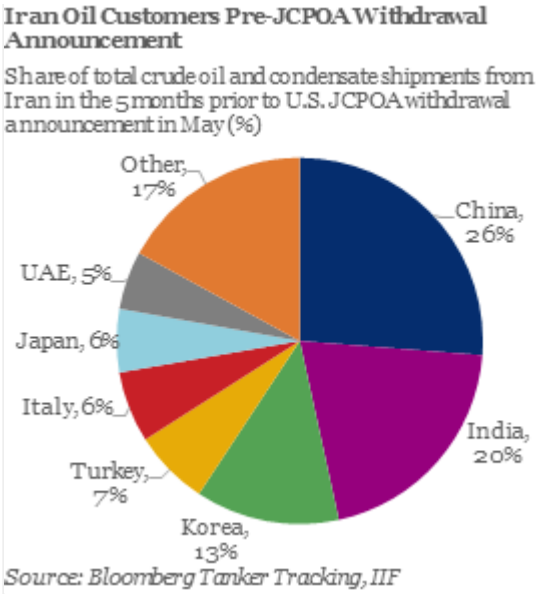
Thanks for reading,

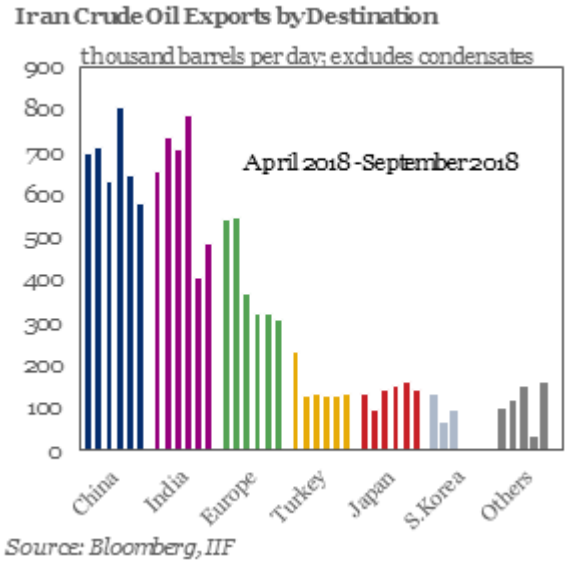
Kristen

Next Phase of Iran Sanctions on Deck

The Trump Administration's 6-month "wind down" period for Iran-related business is set to expire Nov. 4th, at which point the U.S. will reimpose the full range of pre-JCPOA Iran sanctions, including sanctions on financial institutions that process payments through Iran's central bank. As we've discussed here and here, these sanctions do not apply to institutions in countries that have "significantly reduced" their purchases of Iranian crude oil in the previous six months. The Obama Administration deemed reductions in oil purchases of 15-20% as "significant," though we expect the Trump Administration to be more demanding.

Indications at this point are that most, if not all, of Iran's major oil purchasers will attempt to show significant reductions this round to secure Significant Reductions Exceptions that would allow them to avoid these sanctions. China's crude oil imports from Iran have declined from a peak of 0.8 mbd in July to 0.6 mbd in September. China's largest oil refiners did not place orders for Iranian crude for November. Reuters reported that Indian refiners cut their Iranian crude orders by half for September and October.





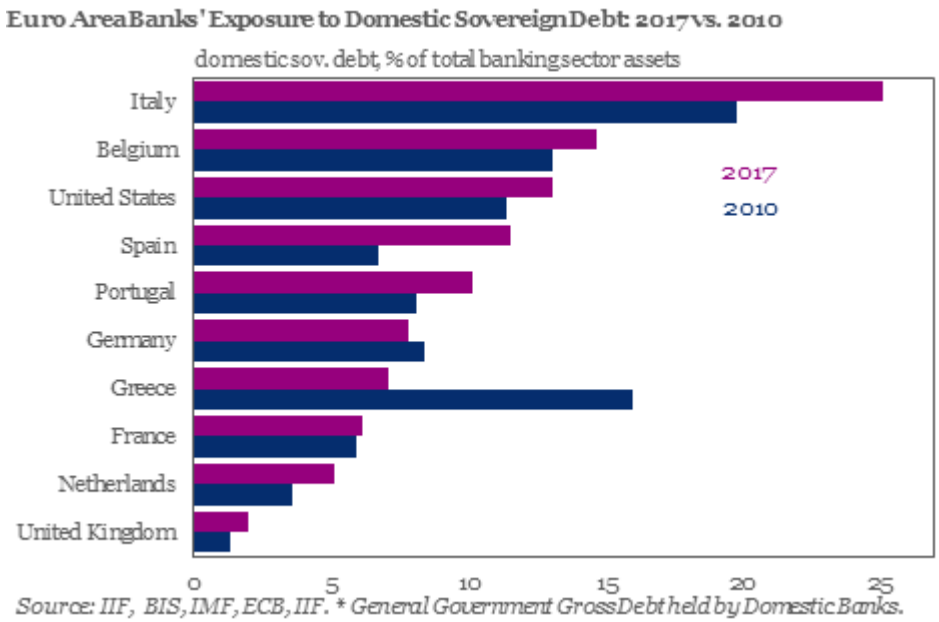
Oil Market. The Trump Administration has said publicly that it does not expect the withdrawal of Iranian oil to impact stability of the oil markets, which they called "well-supplied and balanced." Saudi Energy Minister, Khalid Al-Falih, recently stated that the kingdom has boosted oil production to 10.7 mbd in October, a near all-time high, and that it can increase it more to help address supply shortfalls. The U.S. administration also seems focused on steps could resolve the Saudi-Kuwaiti dispute, which could allow for about 0.5 mbd from the neutral zone, as well as increased production from Kirkuk.

SWIFT Questions. In the meantime, the dispute continues with Europe over U.S. pressure on SWIFT to remove Iranian banks from the system. The approach to SWIFT seems to be still under debate within the U.S. interagency. A number of influential U.S. foreign policy experts have called for U.S. sanctions against individual SWIFT Board Members if SWIFT fails to expel Iranian banks. The European Commission is pushing back on the idea aggressively and has threatened to ban SWIFT from taking action. One possible outcome is that SWIFT, relying on its own corporate rules, would agree to terminate the status of specific Iranian banks if presented with evidence of their illicit conduct. For example, SWIFT's rules allow termination of a user that "demonstrates a conduct which is not in line with generally accepted business conduct principles." It's not clear, however, that the U.S. would be prepared to present SWIFT with this kind of detailed intelligence or that the compromise would be adequate for the Trump Administration. As Amb. Bolton said at a public event in Washington on Wednesday, "maximum pressure means maximum pressure."

Italy: Drawing the Battle Lines

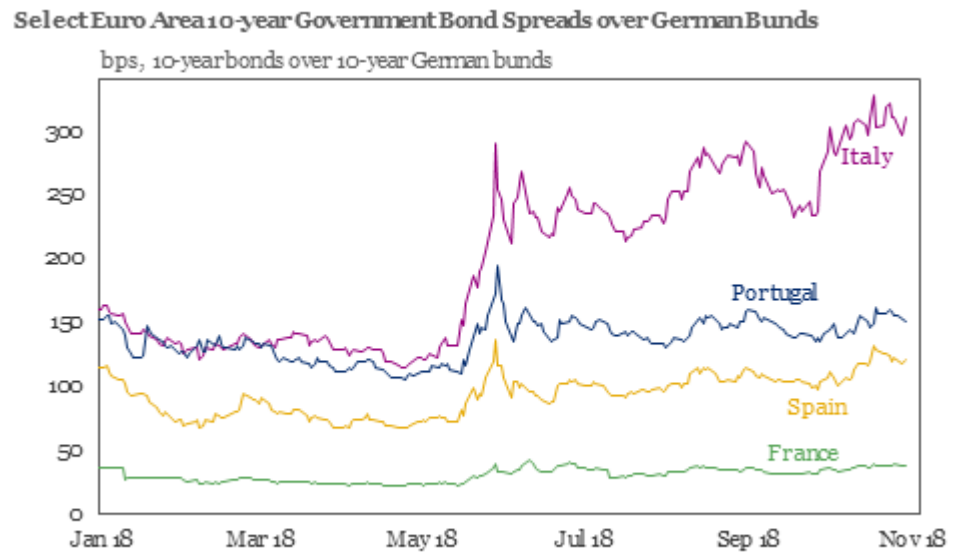
On the heels of the EU's recent rejection of the Italian budget proposal—2.4% of GDP is seen as too high for a country with debt/GDP more than double the Eurozone limit—battle lines are only becoming more entrenched, not least within Italy itself. The objectives are clear: for the Italian government, fulfilling campaign promises and boosting growth; for the EU, preserving the integrity of its fiscal rules and avoiding any reprise of the euro area sovereign debt crisis. As the European Commission noted in a letter to the Italian government this week, "Italy's public debt remains a key vulnerability…a source of common concern for the euro area as a whole."

Our Global Debt Monitor notes that Italian government debt levels are among the highest in mature economies at close to 148% of GDP (market value; about 132% per official estimates). Moreover, this figure does not include Italy's debt to the European Central Bank (Target 2 liabilities) or contingent liabilities if the government needed to provide support for the Italian banking system (which has very high exposure to domestic sovereign debt). Just to stabilize current debt to GDP levels, the government would have to maintain a primary budget surplus of over 1% of GDP—if that does not happen (for example, if growth disappoints), debt to GDP would again be on a rising path. This explains why growth forecasts are another source of contention—the government forecasts 1.5% growth for 2019, up from around 1% this year; but the central bank argues that growth will be "even lower" in 2019.



The stakes are getting higher. Italian unemployment rose to 10.1% in September—well above the Euro Area average of around 8%. Economic growth was stagnant in Q3—the first time this has happened in almost four years. To a populist government, this simply reinforces the case for more public spending. The European Commission is not alone in worrying about the consequences: Bank of Italy Governor Visco warned this week that "the growth divide between Italy and the rest of the euro area is a structural problem that can't be solved by…expanding the government's budget."

Finance Minister Tria has two weeks to send the EU a revised budget. Press reports suggest that the government may try to make the case that the "effective" deficit is really closer to 2%, factoring in a slower timeline for implementation of some spending plans in the current budget draft. But as Italy's battle with the EU wears on, the votes of investors may matter most. Italy's 10yr government bond spread to German Bunds has risen to over 300 basis points—more than any other Euro Area country except Greece. Market pressure has already pushed borrowing costs to levels that could ultimately threaten Italy's debt sustainability—a concern behind S&P's recent decision to cut the ratings outlook from "stable" to "negative."



Source: Bloomberg, IIF

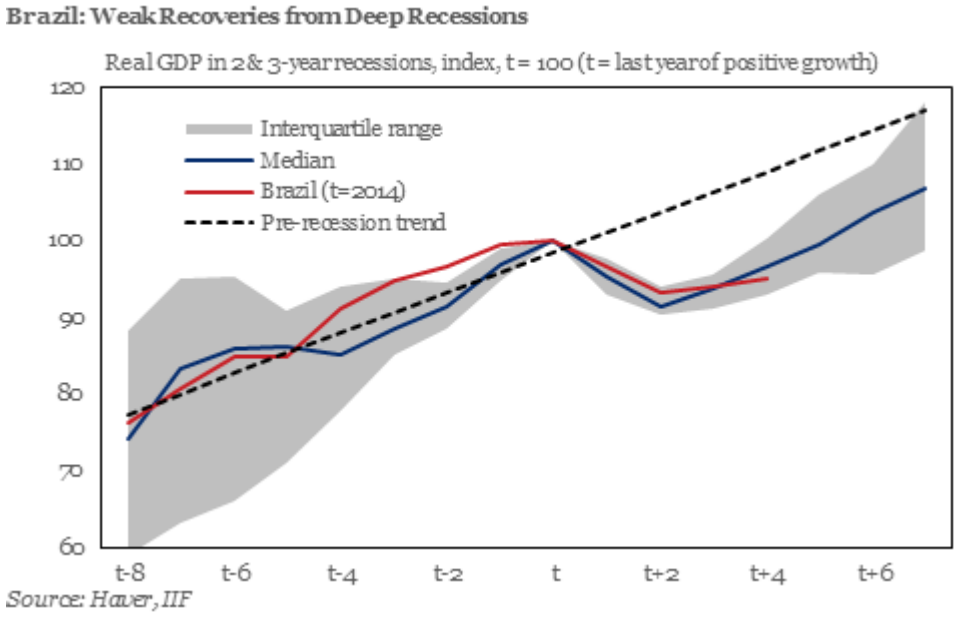
Challenges Facing Brazil's New President

Jair Bolsonaro won Brazil's presidential elections comfortably last Sunday. Results gave him 55% of the vote, ahead of Fernando Haddad, the candidate of the Workers' Party (PT), who had 45%. So far, markets have reacted positively to political change. In his victory speech, President-elect Bolsonaro mentioned debt reduction, eliminating fiscal deficits, reducing the size of the state, and cutting red tape.

He designated Paulo Guedes as his main economic adviser early on in the campaign. Guedes is an economist trained at the University of Chicago, who founded a private equity firm and a liberal-leaning think tank. Onyx

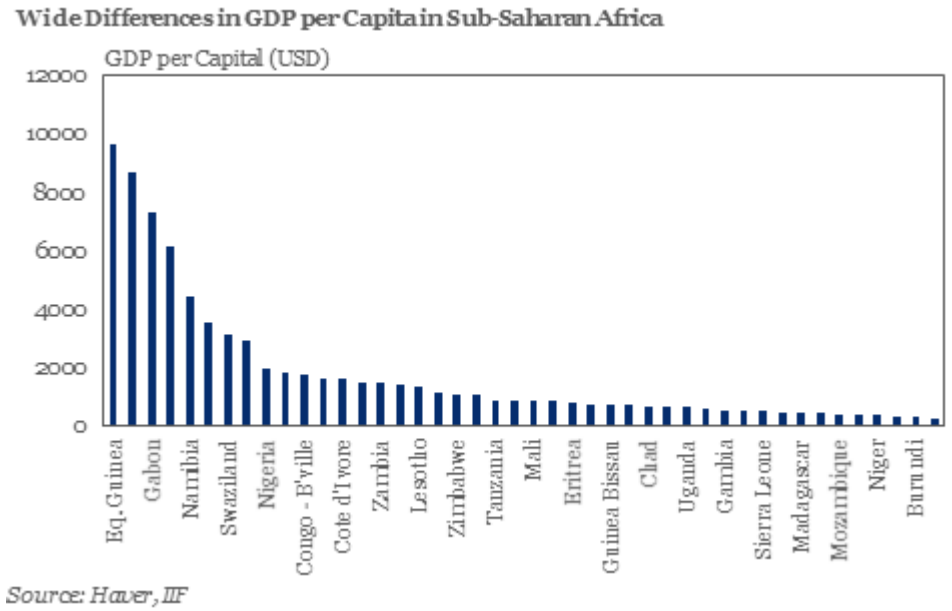
Lorenzoni, incoming chief of staff, announced Guedes will head a "super ministry" combining the current planning, finance, and industry ministries. Guedes appears committed to fiscal discipline and would respect the spending cap in place. He aims to reduce debt by privatizing public assets and is committed to pension reform, an unavoidable measure to reduce fiscal deficits. Simplification of the byzantine tax system is also on the table. On trade policy, Guedes said that, while Mercosur will not be one of the government's priorities, no trade relationships will be jettisoned. Commitment to inflation targeting and deepening labor market reforms also featured in his statements. The new government will not command a majority in the lower house and will have to forge alliances to pass important reforms.

Brazil's growth has been weak since the deep recession of 2015-16, in part due to political uncertainty. In a recent Economic Views, we presented a systematic analysis of deep and long recessions like Brazil's, showing that these types of slumps are usually associated with weak and incomplete recoveries. In the case of Brazil, poor external demand due to the crisis in Argentina is an additional headwind to a strong recovery. However, domestic demand—the engine of past recoveries in Brazil—is slowly picking up and could surprise on the upside if the reforms outlined by the incoming administration are implemented.

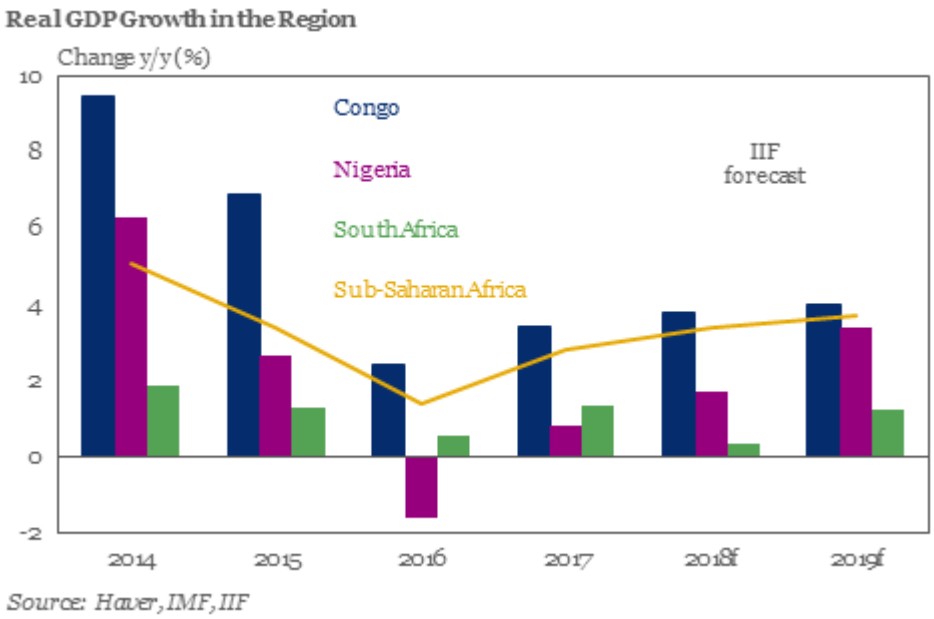


Slow Growth Exacerbates Pressure on Political Systems in Sub-Saharan Africa

In Sticky Notes, we focus a lot of our attention on U.S. policy, which remains a key source of uncertainty. However, we think it's important to remind ourselves on occasion that attention to Washington may be distracting us from important developments elsewhere. In that spirit, in a previous edition, we discussed the election cycle in Sub-Saharan Africa, including presidential elections in Angola, Zimbabwe, and Cameroon. Within the next twelve months, another thirteen countries with a total population of 500 million, including the region's two powerhouses, South Africa and Nigeria, will hold elections. These elections will take place in challenging economic conditions, with real GDP growth averaging only 3-4% in the last two years, not enough to raise income per capita in a region that remains poor and with high inequality. GDP per capita in the richest country, Equatorial Guinea, is more than forty times higher than in the poorest, South Sudan, and real GDP growth varied last year from +10% in Ethiopia to -6% in South Sudan.



Growth in Sub-Saharan Africa has been lackluster since 2015, mostly due to recession in Nigeria and a slowdown in South Africa, the two largest economies in the region. Real GDP per capita declined in 2016 by more than 1%, and the recovery in 2017-18 has been modest. Low growth, high inequality, and ongoing politically motivated violence make for difficult elections. The results so far – in Angola, Guinea, and Zimbabwe – were positive in terms of political progress for these countries. It remains to be seen whether the key countries in the region can achieve the same outcome.



South Africa. Perhaps the most important election will take place in South Africa in May 2019. It will very likely confirm the African National Congress (ANC) as the dominant political party in the country, but political tension comes more from internal ANC disagreements. The party has been struggling with allegations of corruption and elevated violence. Nearly forty ANC regional politicians were assassinated in 2017, mostly after they denounced corruption of local government branches. President Ramaphosa, elected in February 2018, has inherited a weak economy, with real GDP declining in 2018H1. We expect that rising exports will improve growth for the rest of this year, but annual GDP growth is likely to be a mere 0.3% in 2018, the weakest since 2009. However, South Africa is ill prepared for weak growth – it is the most unequal country in the world, according to the 2018 World Bank study. To alleviate pressures from the left-wing Economic Freedom Party, the ruling ANC unveiled a series of proposals to advance black South Africans, including changes to the mining sector charter which would raise the level of black ownership from 26% to 30%, with 20% reserved for business interests, 5% for communities, and 5% for employees. An alternative plan would amend the constitution to allow for expropriation of white-owned land without compensation. This proposal has faced strong opposition from the private sector and will be evaluated by a presidential advisory panel, but remains a possibility.

Germany: The Impending End of an Era

German Chancellor Angela Merkel rattled European politics this week by announcing she will not seek re-election as CDU leader at the party conference in December, paving the way for her to step down as Chancellor when her current term ends in 2021 – or likely earlier after a new CDU leader is established. Her announcement followed major losses for the CDU/CSU-SPD coalition in the Bavarian and Hessian state elections in October, largely seen as a rebuke of Merkel (voters' dissatisfaction with her is now above 50%).

Migration has remained a thorn in Merkel's side since the peak of the refugee crisis three years ago, as infighting this summer within the alliance over migration policy threatened the fragile governing coalition. While not entirely surprising given the heightened volatility in German politics over the past few years, the impending end of the Merkel era – CDU leader since 2000, Chancellor since 2005 – adds further uncertainty to an already fractured European political environment.

An Intriguing Political Landscape. The resilience of the political center has long been a source of stability in German politics, but its complacency has also fostered a rise in parties at both ends of the spectrum over the past decade. Similar to anti-establishment movements around the world, the German electorate has been less likely to choose the continuity of a more bipolar system, in favor of a less certain change of direction that comes with a multi-polar approach.

The center-left Greens have surged above 20% support to just 5% behind CDU/CSU in recent opinion polling. Right-wing populist Alternative for Germany (AfD) appears to have hit a ceiling below 20%, though still above

its 2017 vote total. SPD has fallen into a historically unfamiliar fourth place with nearly 15% support as it loses supporters to the Greens and, to a lesser extent, the Left. Increased fragmentation of parties will create a challenging path to a majority coalition involving CDU/CSU – though a CDU-Green alliance, replicating a relatively successful relationship in a few states, could be in the offing.

Who Will Follow Merkel? Three candidates have already emerged in the race for next CDU party leader: Annegret Kramp-Karrenbauer (AKK), CDU's Secretary-General; Jens Spahn, Minister of Health; and Friedrich Merz, a former CDU foe of Merkel and long-time member of parliament – though he has been in the private sector for nearly a decade. AKK is seen as closest to Merkel and her hand-picked successor. Spahn and Merz are both to the right of Merkel; Spahn has gained popularity in part due to his criticism of Merkel's migration policy, while Merz has leveraged his former party status as the more traditional, pre-Merkel, CDU option. Initial opinion polls show Merz with a modest lead over AKK, with Spahn a laggard. However, nearly half of respondents are still undecided.

While it seems unlikely that Merkel will serve out her full term as Chancellor to 2021 regardless of the next party leader, an AKK win will provide a more gradual succession, while a Merz/Spahn win could push for her ousting sooner. Either way, Merkel should be able to keep the center-right European People's Party (EPP) on course for relative success in the 2019 European Parliament elections and help determine key posts for the next Commission. Therefore, we do not anticipate an immediate change at the EU level. Nonetheless, with Merkel on the way out, many have observed that the proverbial "leader of the free world" crown now lands squarely on French President Macron's shoulders – perhaps more of a curse than a blessing.

Tweet of the Week

Brad Carr, and our innovation and regulation teams, were in Brussels this week for the Digital Finance Regulation Symposium. Videos of the panel discussions are available here.

We'll share some of our reflections next week, but in the meantime here's something to chew on:

NPR
@NPR

Follow

In Sweden, thousands of people have had microchips inserted into their hands.

The chips are designed to access users' homes, offices and gyms by swiping their hands against digital readers.

Thousands Of Swedes Are Inserting Microchips Under Their Skin

Proponents of the chips say they're safe and largely protected from hacking, but one scientist is raising privacy concerns around the kind of personal health data that

npr.org

James O'Malley
@Psythor

Follow

Here's a dystopian vision of the future: A real announcement I recorded on the Beijing-Shanghai bullet train. (I've subtitled it so you can watch in silence.)

3:34 AM - 29 Oct 2018