Sunday Wrap

Happy Sunday,

This past week saw another heavy dose of confusion from global politics and policies, the global growth outlook and of central banks' reaction functions – as well as their perceived ability to prevent the economic consequences of misguided politicians. As a result, markets were all over the place during the week, but ended up strongly with sharply higher stock markets and European sovereign spreads tighter.

As you know, we at UniCredit have long argued that a US recession in 2020 is the most likely outcome, and that the descent to about zero growth will lead the Fed to cut three times. In our central forecast, Europe will cruise quite nicely until we get hit by the US – and thereby global - slowdown. And, as I have argued more recently, the key risk to this forecast is not one of "no US recession", but one of a sooner and sharper slowdown because of disastrous US policies.

This risk has now increased, not least as indicated by Friday's two big disappointments, namely the US job numbers and German industrial production. As I'm sure you noticed, the US economy added only 75,000 new jobs in May (about 100,000 less than expected), and average hourly earnings growth dropped to a meagre 0.2% mom, which is going to hurt the American consumer at a time when price inflation gets boosted by Trump's tariffs. Meanwhile, in Germany, industrial production dropped 1.9% mom in April, pulled down by a 3.7% mom plunge in exports, the worst monthly performance in more than three years. Auto production was down an eye-watering 5.6% mom.

The world's central banks have been struggling for months navigating between the (until now) decent growth numbers and the huge risk from Trump's trade policies; a risk that Fed governors have found politically difficult to articulate in terms of their reaction function. No wonder Powell has sounded like blowing hot and cold at times. But as I discussed last Sunday, markets have begun seeing the writing on the wall, sending inflation expectations south and inverting more of the curves. So, on Wednesday, Powell sounded like a rate cut may be in the cards, causing additional confusion as to whether they'll simply be reacting to markets. But make no mistake about this, this is getting dangerously circular: Chasing markets is a losing proposition for a central bank – and for stock markets to like weak economic numbers in anticipation of a rate cut is an equally losing proposition. And if you add the two …!

The ECB has been facing the same dilemma. Exports have been hurt, but eurozone domestic demand has been cruising very nicely: Excluding the volatile changes in inventories, real year-on-year domestic demand has been increasing by an average of 1.7% since the beginning of 2018, accelerating to 1.9% in Q1 of this year. And there are indeed a few "green shoots" on the European data front, including the important Ifo business expectations component, which promises well for the next reading of our (very reliable) leading indicator.

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But the fear of Trump's man-made mess has been easy to detect in the ECB's communication, and as the very latest numbers started to ease, inflation expectations plummeting and Trump sending further disturbing signals, the ECB sent an unmistakably dovish signal on Thursday, extending forward guidance, telling us that after that period, rates could not only go up, but also down, and QE could start again (personally, I don't really get the role of forward guidance with this message, but I'll discuss that another day) – and in an attempt to ease the pain for banks and hence the transmission mechanism, handsome pricing terms were announced for the TLTRO.

But while the world's two most important central banks are doing warm-ups for further easing, two other important central banks out there in the crossfire - Australia and India – hesitated no more and went ahead and cut rates this past week.

So, that's where I think we are today: no shortage of uncertainties for the world's central banks when navigating the uncertainties caused by the winds of nationalism. In today's note, I'll reflect on this mess in politics:

- Very briefly on the US and UK.
- Mostly on Italy and the additional confusion out of Rome on mini-BOTs and on Conte's threat to resign.
- But I also note a couple of (small) bright lights when it comes to the hope of a push-back of extreme nationalism, namely from my native Denmark and from Germany's Bundestag.

1. The US and UK: Great powers in decline as a result of far-right nationalism?

I have written plenty about the dangers imposed on the world by nationalism, as demonstrated primarily by Trump, so I'll keep it very short here. But I have to note the illustrations from this past week of the consequences of Trump's recklessness:

As you know, early this past week, Trump took his tariff weapon beyond trade issues and threatened additional levies on US imports from Mexico unless the Mexican government steps up its efforts to stop the illegal migration into the US. Not surprisingly, markets didn't like it, but Mexico quickly pledged more enforcement, and Trump took the threat off the table on Friday (for the time being) – and markets love it…

But, as illustrated by presidents Putin and Xi in St. Petersburg (and by the naval provocations in the Pacific), bigger nations don't react well to Trump's bullying. Putin significantly stepped up the rhetoric by referring to US "trade wars [and] using arm-twisting and scare tactics … [as] a road to endless conflicts … and maybe not even only in trade … figuratively speaking, an all-out brawl with no rules" – while Xi, accompanied by Huawei CEO Guo Ping, noted that China's ties with Russia are now "at their highest level in history". If anyone thinks this is good for global trade, investment and growth, they really need to think again.

More broadly, being able to unite China and Russia against you, after decades of mutual suspicion, is quite an achievement for Trump. It now seems rather easy – if frightening – to imagine a world, which Singapore's PM Lee Hsien Loong warned about just a week ago at the Shangri-La Dialogue, namely one in which the rest of the world needs to choose between China and the US as trading and investment partners. Well, Russia seems to have made its choice, in spite of having helped Trump to the presidency. That this environment calls on Europe to unite is glaringly obvious to me, and - I hope - to you.

But it's still not clear to everyone here in this Dis-united Kingdom. For Brits, another milestone in their sad descent into the implications of nationalism was reached on Friday when Theresa May stepped down as PM – although she remains in No 10 as caretaker PM until the Conservative party has elected a new leader. That process starts officially tomorrow, Monday, and concludes within about a month. But make no mistake about this, a change of prime minister is unlikely to lead to an end to the implosion of British politics we have witnessed since the Brexit vote. And as that happens, the probability of an orderly Brexit declines (while, ironically, the probability of a reversal of the decision goes up, if still only a small chance.)

And, for what it's worth, my view is that should the favorite, Boris Johnson, win the conservative leadership contest and become prime minister, the UK could well descend even further in its global standing and influence. I certainly cannot recall a more disastrous British foreign secretary than Johnson, if that's anything to go by, and as he formally launched his campaign with a major interview in the (Murdoch-owned, pro-Brexit, Boris-friendly) Sunday Times today, Boris Johnson said that our "partners need to understand that the money [the 39bn pounds agreed by Theresa May to pay for the UK's share of already delivered goods and commitments] is going to be retained until such time as we have greater clarity about the way forward. I always thought it was extraordinary that we should agree to write that entire cheque before having a final deal." Make no mistake about this: This is the front-runner to be the UK's next prime minister threatening to run up arrears – if not outright default – on commitments made by the UK.

Some years ago, I wrote a brief paper arguing that the UK is amazingly similar to Italy in terms of economics, therefore wondering about their more favorable sovereign funding costs. I was then kindly reminded of the key difference: The messier politics in Italy. I now wonder if the UK may not have managed to beat Italy on that one as well. Either way, Boris has certainly teed up my next sections very nicely:

2. Italy: mini-BOT confusion, and the possibility of early elections.

As suggested above, the political consequences of nationalism haven't yet reached the level of chaos in Italy presently on display in London and Washington, but the cost to growth is more visible in Italy. Italian GDP has slowed relative to the rest of Europe since the present coalition came to power a year ago, as uncertainty about policies dampened investment and boosted precautionary savings.

The main uncertainty in Italy this past week (the prospect of securitization of public sector arrears, possibly with so-called mini-BOTs) is rooted in the government's confusion about the sources of structurally weak Italian growth.

There are a number of economists, including influential ones close to the Italian government, who believe the euro is a key reason for Italian underperformance, and the leaders of the coalition have never fully put this idea to bed. Admittedly, on Friday, Salvini said that there is no plan to leave the euro, but given his less-than-clear commitment in the past, why doesn't Salvini, and di Maio for that matter, completely kill off any further speculation about alternatives to the euro by saying something like "Italy will remain part of the eurozone, period, and if any of our subordinates were to express a different view, they'll be asked to resign"?

As I have written on numerous occasions, the euro is not to blame for years of weak Italian growth – rather, it has delivered stability (and influence) to Italy. If you think otherwise, explain to me why it should have hurt only Italian growth and not that of other members? Explain why Slovakian (real per capita) growth has been stronger, and more stable, than Czech growth since Slovakia adopted the euro? And/or, give me an example or two of countries which have devalued themselves to sustainable prosperity.

But given the influence in Rome of a number of people elected on a platform of resentment towards others (it's the euro's fault, Brussels' fault, Germany's fault…), who have mused publicly about former Greek Finance Minister Varoufakis' plan of leaving the euro by first introducing a parallel currency, and even suggesting that mini-BOTs could be issued and then made into legal tender as a parallel currency, they have managed to attach a huge degree of stigma to the otherwise sound idea of addressing the public sector arrears via securitization.

So, when the Italian lower house voted – unanimously – on May 28 for a (non-binding) motion "to guarantee compliance with the terms of payment of commercial debts of public administration and thus to respond to the infringement procedure that the European Commission has initiated against Italy on the implementation of the directive on delays of payment … possibly including through instruments such as small-denomination securities", all hell broke loose in the commentariat and markets.

To remind you, the Italian government has EUR 53bn, or some 3% of GDP, in outstanding arrears. The stock of arrears peaked in 2012 at almost 6% of GDP and has been declining each year since then. The arrears are known and reported by Eurostat, but according to Banca d'Italia, only about EUR 10bn (0.6% of GDP) is included in the statistics for public debt.

Needless to say, arrears should never have been allowed to accumulate in the first place, and while they have been reduced in recent years, it's advisable to formalize this debt. But since the size is too big to eliminate it all instantaneously by issuing new debt, it makes sense to offer creditors of these arrears a short-dated security to: (i) formalize the debt, (ii) provide an agreed-on term structure and interest rate, and (iii) convert it into an instrument which can be traded (at whatever price the market sets), if they so wish. Importantly, however, an exchange of the arrears for a security must be voluntary on the part of the holder of the claim, so to make it happen, such securities must have sufficiently attractive terms, relative to market conditions.

But now comes the problem caused by the confusion and uncertainty which political leaders haven't been willing, or able, to put to bed: As noted above, these small-denomination securities, the mini-BOTs, have been mentioned in the past by voodoo-economists as a vehicle to introduce a parallel currency, hence as a first step on the way out of the euro, so investors and commentators alike extrapolated from this non-binding motion all the way to a utopian end-station. To illustrate such a step-by-step descent into ruin, I heard a suggestion (not from an official) that a mini-BOT could take the shape of that traditional April Fools' Joke of "perpetual zero-coupon securities". To be clear, that would make them value-less, and not a currency.

Here is why this crazy parallel-currency idea will never come to fruition:

First, securitizing arrears does not mean that these new (small-denomination) securities are currency. They are either "debt" or "currency", as Mario Draghi put it on Thursday and, as he noted, if it's a "currency" it's illegal, implying that the ECB, as the sole issuer of currency in the eurozone, would take legal action against the Italian government. The only way such a security (or anything else) could become a "currency" would be by making it "legal tender" (the definition of a currency), which happens when a law forces all economic agents in the country to accept them as payment, at par, for goods, services and taxes. To my knowledge, such legislation has not been contemplated by anyone of importance, let alone passed. But given the less-than-clear communication by the government, this needs to be watched.

Second, with or without legal action, a parallel currency issued by the state rather than by a central bank, would – without a shadow of a doubt – immediately trade at a steep discount to the euro. So, does anyone really expect that any provider of goods or services in Italy would voluntarily accept payment in such a parallel currency rather than euros?

Third, if the tax authorities were to accept such a parallel currency at par for tax liabilities, it would probably hold some value for a time, although it would be rather inconvenient for citizens and businesses to store this “parallel currency” until the taxes have to be paid because banks would surely not breach European law and accept them as deposit at par (but banks and other financial services firms would probably be prepared to make a market for them – and if not, as you see in some EM countries, ‘the street” will).

Even so, if you assume such securities could be used, at par, to settle tax liabilities, the budget would be short of usable currency to pay public sector salaries and procurement, so the cash deficit would explode. Should the government then try to pay part of its salaries or procurement in this parallel funny-money, it wouldn’t be difficult to imagine the (lack of) enthusiasm of public sector employees and providers of goods and services to the public sector.

You see where this leads to: You can’t introduce a new parallel currency and hope it can compete with the euro without introducing capital controls (and enforce that with strict border controls), while freezing deposits. How long do you think the government would stay in power if they started down this road – or even contemplated a “cold turkey” move to such a new regime, as, reportedly, Varoufakis tried to do in Greece at the depth of the crisis? Anyone with a background in EM will have witnessed the implications on the economy and on political stability of governments printing money and/or trying to fence in any hard currency in the country. When people realized that Varoufakis toyed with these ideas in Greece (and when they understood what they meant), he was out. I suggest the same will happen to others playing with such catastrophic ideas.

My point is this: You can create an attractive security and offer it in exchange for claims based on non-payments (arrears), thereby formalizing the liabilities, and if done right, that’s a good thing. But you cannot make it legal tender – for legal reasons and for common sense reasons. It’s a complete non-starter, and the government should make clear that it understands this.

But as noted, coherent policy communication hasn’t been the coalition’s strongest side this past year. And finally, on Monday, the competition between the two partners to offer the most populist policy suggestions became too much for PM Conte. So he called a press conference to say that he had been "naive in thinking the two parties would settle their differences after the European election" and that "the next budget law must put the country's public finances back on track because EU rules won't change until we manage to change them." Threatening to resign, he added that "it's up to the political forces to decide whether they want the government to continue ... I want a quick response because the country can't wait."

I’m sure that this was triggered by Conte getting nervous about the implications of the coalition partners’ squabbles for the 2020 budget plans - and by threatening to resign, he is indicating that he may be giving President Mattarella an excuse to call early elections. It’s crunch time for that decision because of the timing for the 2020 budget preparation: Only by calling early elections now (which would take place only after the summer break, probably in late September) would a new government have a chance to put a draft budget together in time for the mid-October deadline for sending it to the European Commission (and parliament).

And if a new budget cannot be agreed on in time, the law simply extends the existing one, which would imply a fiscal tightening as revenues will be boosted by the already agreed on VAT increase (worth 1.3% of GDP) that will come into force at the beginning of next year; hardly an attractive legacy for the coalition.

We shall see. As always, if you want to discuss Italy – politics, budgets, arrears or food and wine – my colleague, our chief Italian economist, Loredana Federico, stands ready…

3. The glimmers of hope…

Whether nationalism is about to suffer defeat in the US, UK or Italy I don't know, but I know it suffered two serious blows this past Wednesday - in the Danish elections, and in the German Bundestag.

In Wednesday's elections, the Danes put another nail in the coffin of Northern European nationalism when the xenophobic, EU-sceptic, Danish People's Party (DPP) was crushed, as particularly women and young voters swung heavily towards parties which had campaigned for more humanitarian policies towards foreigners and green issues. Denmark thereby followed the new trend in recent elections elsewhere, including in Sweden and Finland.

I won't bore you with the details, but I'll suggest the following three take-aways as possible lessons for how to interpret the political mood elsewhere in Europe:

First, the far-right EU-sceptic DPP dropped to 8.7% of the votes after having received more than 21% in 2015. This happened because: (i) the Social Democratic party, under the new leader, Mette Frederiksen, at 41 years old now destined to become Denmark's youngest-ever PM, had shifted to a tough stance on refugees (but none of DPP's other nationalistic trademarks), and (ii) competition from a new (ultra-extreme) right party, founded and led by convicted racist Rasmus Paludan, which took 1.8% of the vote (which is below the threshold for representation in parliament – but still 1.8% too many, to be sure!)

Second, while the Social Democrats' policy shift on refugees ended years of decline, they didn't gain either (their voting share was marginally down, but due to the math, they gained one additional seat). More remarkably was the gain by a number of smaller parties around the middle and on the left, which campaigned on a "humanitarian stance" on refugees, as well as on climate issues, and an (equally understandable) outrage over the perceived softness of the massive banking scandals which have engulfed Denmark lately. In all, the shift showed a return to the traditional center- and center-left parties, a more humanitarian preference, and a more pro-EU stance.

Third, in spite of the clear shift in Danish political sentiment, it is not clear at all how Mette Frederiksen will manage to form a stable government. In addition to this new division between the Social Democrats and the rest of the center-left over refugee policies, it'll be a massive challenge to agree on economic policies between the co-called Radical Left (which, in spite of its name, is a pretty business-friendly center-right party; the party of Commissioner Margrethe Vestager) and traditional left-leaning parties; all necessary for a majority.

If Danish politics interest you, please call…

Meanwhile in Germany, the far-right also suffered a blow on Wednesday, when the Bundestag had called in a number of experts to explain the Target-2 system to politicians. As you know, a number of professors, including Hans-Werner Sinn, and political parties, predominantly AfD, but also – to a lesser extent – FDP, claim that Target-2 exposes Germany to huge risks, if not outright hidden transfers, to other eurozone countries.

As professor and member of the Government's Council of Economic Advisor, Isabel Schnabel, tweeted afterwards: "Broad agreement that Target [2] is overall working well & that risks have been exaggerated. No agreement on whether Target [2] liabilities are loans (they are not). Deeper problems are lying elsewhere, especially in the banking sector" – you can say that, given the state of the German banking industry… adding: "This is now the official obituary of the Target2 debate".

Bravo, Isabel! – and respect to the Bundestag for asking experts to clarify matters. If only other parliaments would call in proper experts, listen to them, and act on that basis … The Bundestag's press release is here (in German): Experten wollen Target-System beibehalten

And on that note, Covent Garden needs me, and I'll be on my way…

Best

Erik

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MR 19/1

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