Sunday Wrap

Happy Sunday,

Berlin is in shock this morning following yesterday's announcement that SPD members voted for a sharp shift in the party's leadership, thereby seriously questioning the governing coalition. SPD members voted for Norbert Walter-Borjans (a former finance minister of North Rhine-Westphalia) and Saskia Esken (a not very well-known MP from Baden-Wurttemberg) to lead the party, rather than the duo of finance minister Scholz and Klara Geywitz. The vote will have be confirmed by the delegates of the SPD convention next week, but that'll be formality.

Walter-Borjans and Esken campaigned on a more left-leaning platform than what SPD and Scholz stand for, including a demand for substantially higher public infrastructure investment and an end to the peculiar "Schwarze Null" obsession. They also promise an increase in the minimum wage to EUR 12 an hour, from about EUR 9 now. Walter-Borjans says that SPD's continued participation in the government coalition will depend on CDU/CSU agreeing to their demands.

Not surprisingly, the media speculation (as well as here in my local coffee shop) focuses on a likely end to the coalition with most people expecting Merkel to manage to continue as head of a minority CDU/CSU government until early 2021, i.e. through the German EU presidency during the second half of next year. A few observers dispute this scenario and think early elections within a few months will be more likely. Others expect that CDU/CSU will give in on a sufficient number of new SPD demands to keep the coalition together for another 18 months.

One thing seems clear to me, namely that the shift in SPD leadership will further raise the political uncertainty in Germany, thereby making the necessary European reforms, including banking and capital markets union and reforms of the ESM, much harder during the next year or so. (And no, it will not increase the probability of any meaningful German fiscal expansion during the next 6-12 months.)

In all, this additional uncertainty is not good news for von der Leyen on this first day as president of the European Commission - but there you go. And, I'm afraid, it's far from the only major challenge facing her, the new Commission or Europe more broadly.

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I'll use today's not to highlight two key challenges – and to suggest just a little hope at the end. Specifically:

- **I'll discuss two concrete examples (within just weeks of each other) of the destructive power of Trump's approach to multilateralism, and of China's ambitions to become the new global leader – and I'll suggest what should be Europe's response.**
- **I'll return to my long-held obsession with investment, today leaving aside the issue of public sector investment, but rather use the just released 2019 Investment Survey by the EIB to highlight the key messages to European policy makers, including the ECB and the new Commission, for private sector investment.**
- **And I'll end with possibly slightly better news as it is emerging that most economists are a bit less worried about an economic slowdown next year than we are in UniCredit Research.**

1. Trump's destruction of critical multilateral institutions, China's attempt to pick up the mantle – and my two cents worth on what Europe should do.

While President Trump's lack of appreciation for the benefits to all, including the US, of multilateralism has long been clear, too many commentators and market participants seem to be rather relaxed about the danger of his policies. But make no mistake about it, his policies are destructive in a very concrete way.

Take the latest example as it's about to unfold: Without a doubt, the WTO has many faults, not least its staggering average 3 ½ years spent on trade disputes to make their way through panels and appeal rulings, but it is the only existing body for global trade dispute settlements. But in less than two weeks, this important multilateral function will cease to exist when, on December 10, two of the remaining (critical) three judges on the Appellate panel will retire without anyone having been nominated to fill their positions, a process blocked by the US.

To be sure, previous US administrations have complained about the WTO, including the role of the Appellate body which they claim has grabbed power relative to the member states by creating new trade laws through its rulings. The EU and others have been more sympathetic to the Appellate body's conduct. But while previous US presidents complained and blocked occasional appointments, Trump is now about to take the issue over the cliff by blocking new appointments at a time when the critical number of judges on the final dispute settlement panel will no longer be in place.

Without an accepted dispute settlement system, the risk of tit-for-tat escalation of trade disputes between countries will increase significantly without a defined process to end it (even if only after 3 ½ years), thereby potentially sending global trade into still deeper trouble. Needless to say, in such a world the big guys will win over the smaller guys, but to the detriment of everyone because this is not a zero-sum game. And, when it comes to trade, the world is really just made up of three powers: The US, the EU and China. (Anyone listening in London?)

I have argued before how Trump's tactic of focusing on single issues without seeing the bigger picture is a deeply misguided – and indeed amateurish – way of conducting policy, and the examples keep coming. Take this present one: One of the Trump administration's complaints about the WTO is its lack of attention to China's questionable respect for intellectual property rights.

Yet, when it comes to protection of intellectual property rights, I can't help but notice the madness of the Trump administration's attack on the WTO while withdrawing from various organizations – or of the irony of the Chinese government now having formally nominated a former Chinese government official, Wang Binying, as the next director general of the UN's World's Intellectual Property Organization, WIPO. (For good order, I should note that Wang is presently deputy director general for the WIPO's Brands and Design Sector, and probably technically completely competent.)

Wang is the seventh nomination for the WIPO job, and – as far as I can gather from comments published in global media – she is unlikely to be appointed. Yet, the case is a clear example of Trump barking up the wrong tree, taking his eyes off the real functioning of the world. Wang's nomination is also a sign of China's ambition to take a greater role in various multilateral organizations. Yet, it doesn't seem crazy in the present environment when former deputy secretary general of WIPO, James Pooley, says that Wang's candidacy is an attempt to "put the fox in charge of the henhouse". Pooley no doubt was referring to the fact that patent applications remain confidential with WIPO before they are approved and made public.

So this is the world von der Leyen is facing as she, and her new Commission, take office today. Here is my two cents worth on what the Commission's reaction should be to this global power vacuum, all to be pursued simultaneously:

First, the EU should surely work with whoever is willing to participate in repairing and strengthening the WTO and its dispute resolution mechanism, even if this leads to an organization and system without the US. This will need to include providing the necessary funding to the WTO when its budget comes up next year. The US has threatened to withhold its financial contribution, which is regrettable, but others must take charge then. Also, the EU should pursue the work that reportedly has begun with Canada to establish a shadow appeals panel, and seek to sign up as many other countries as possible.

Second, the EU should continue to tell the US administration - loud and clear - that Europe is prepared to discuss trade issues, but that any bilateral tariffs or other trade infringements outside WTO rulings, or under the guise of "national security", are unacceptable and will be met with proportionate measures, maybe particularly targeting businesses in political swing states. To emphasize that Europe prefers a close and cooperative relationship with the US, Washington should be von der Leyen's first trip out of Europe as Commission president – and the sooner the better.

Third, the EU should insist that the Chinese government respects intellectual property rights and that a verifiable process is set up to police it. As Reagan famously said about disarmament negotiations with the Soviet Union: "Trust but verify". Intellectual property rights are an integral part of trade and investment policies, including in the digital area. WIPO is important, but it'll also need to be an explicit component of a revamped WTO.

2. European investment: Latest trend, and key policy issues.

I have written lots about the troublesome years of under-investment in Europe, both in terms of grossly insufficient public investment, but also in the private sector. Today, I'll focus on private sector investment, benefitting from the just-released annual investment survey of more than 12,000 companies by the European Investment Bank. It's one of my favorite surveys; I'll summarize it and draw key conclusions for policymakers. The survey for the EU is here: EIBIS 2019 - EU overview.

The good news is that, according to this survey, in 2019 there were still more European firms expecting to increase than reduce their investment activities during the next 12 months, but – not so good – the net balance between the two declined. In the same mode, the share of firms in the EU investing in 2019 declined to 85%, the same as for the US. But within the EU, only Germany, Austria, Belgium, Denmark, Sweden, Finland and Slovenia had a higher percentage of firms than the EU (and US) average expecting to boost investment in 2020. At the other end of the spectrum, Bulgaria and Hungary had the lowest share of firms investing this year.

A higher percentage of large firms invested this past year than among SMEs. The manufacturing sector saw the highest share (92%), which is encouraging – if a bit surprising – given the slump in global manufacturing. In comparison, the services sector had only 79% of firms investing this year.

This past year, European firms said that 62% of their investment was funded by internal financing, while most of the remaining external financing was funded by banks (58%). In other words, less than 25% of firms' total financing is funded by banks in Europe.

And now it's getting more interesting: When asked about the drivers versus constraints of their investment decisions for the next year, decision makers pointed to the political and regulatory climate as the single biggest deterrent, with almost 30% more firms expecting this to get worse rather than getting better over the next 12 months. The general economic climate was a close runner-up in terms of the outlook being a deterrent for investment. In particular, large manufacturing businesses worry about the economy next year, according to the survey. Asked whether they thought the outlook for their specific sector would get better or worse, a small majority was optimistic (particularly in construction and among SMEs). Companies were also net positive about the short-term outlook for the availability of internal (and, to a lesser extent, external) financing for their investment needs.

Yet, the outlook for all five areas of drivers versus constraints (political/regulatory climate, economic climate, outlook for the specific sector, availability of external finance, availability of internal finance) deteriorated in the 2019 survey compared with expectations a year ago – and, interestingly, European firms are more worried about the outlook in all five areas than US firms, particularly when it comes to the general economic outlook.

Asked about the longer-term drivers versus constraints for their investment decisions, businesses (in both Europe and the US) named two major obstacles, namely the lack of availability of skilled staff, and general uncertainty about the future. Other key obstacles for investment include business and labor market regulations and the cost of energy. Among the nine categories of suggested obstacles, availability of finance is rated the least important obstacle – and, interestingly, while the rating of the severity of the nine obstacles is amazingly similar between European and US companies, the largest difference is with respect to the availability of finance where US companies say they face less of an issue than what's reported by European companies.

Finally, the survey includes a question whether firms have received less than desired external financing due to having been rejected, having received less financing than requested or because it was deemed too expensive, or simply having been discouraged. In Europe, a little more than 5% of the surveyed firms say they have suffered from not receiving as much external financing as desired due to one of these reasons, broadly the same as in 2018. Such experiences are a bit more common in the US, according to the survey. But when it comes to firms feeling they have received less than desired external financing, big variations prevail inside the EU, and indeed inside the eurozone. More than 10% of firms in Greece, Latvia, Lithuania and Poland report such insufficient availability of desired external financing. In the other extreme, only a couple of percent of firms in Germany, the Netherlands, Austria and Sweden report such constraints on external financing.

So what's the key message for European policymakers? Pretty clear, I think. To boost private investment:

First, businesses ask for less political and regulatory uncertainty for the future. Message: Berlin, are you listening? And, more concretely, to all of Europe, stop recent years' free-lunch approach to regulatory changes by multiple different bodies, and agree instead, e.g., on a 5-year plan.

Second, firms need more skilled staff. Message: Facilitate easier immigration of high-skilled labor from outside the EU, and encourage it via further tax incentives. Also, allocate serious money (e.g. 1% of GDP) to a pan-European program of higher technical education.

Third, businesses need better prospects for demand for their products. Message: Boost demand with a sizable and well-targeted fiscal easing.

Fourth, availability of attractively priced external credit is not a significant issue, probably partly because of the availability of abundant internal finance. Message: The ECB should feel pleased with what has been achieved here, but it also argues against further policy changes to push on this string. Separately, the abundant internal finance already available needs to be encouraged to get employed in productive investment, which can be achieved by changes to the tax and regulatory regimes.

3. Maybe better news: Feedback on our 2020-21 outlook.

I spent this past week presenting and discussing our (revised) outlook for 2020-21 to a number of clients as well as to a group of 35 chief economists from buy- and sell-side financial firms, as well as from a number of official institutions, organized by the EIB in Luxembourg.

As you'll hopefully recall from my note last Sunday (or, even better, from reading my team's report published on 21 November), we expect global growth to slow further as the US moves towards a mild recession, probably during the second half of 2020. Eurozone growth will be barely positive during the same period. In our view, it's a cyclical slowdown, not a crisis, and we expect both US and Europe to recover back to close to trend growth rates at the end of 2021. That said, the longer-term growth outlook will almost certainly be burdened by the roll-back of globalization, years of under-investment in both Europe and the US and by demographics.

The feedback from this past week suggests that we at UniCredit Research are now among the most bearish forecasters when it comes to the 2020 outlook, a rather unusual feeling to be honest. Most interlocutors doubt that US growth will ease much so long at monetary conditions remain this accommodative, and while – we all agree, apart from the Fed itself – that the Fed stands to cut rates further. Some also expect some unidentified dose of 2020-magic from Trump as he'll try to avoid a slowdown during the election year.

Who knows who'll turn out to be right, but I find it difficult to ignore our recession probability models, which all point to a 50%-60% chance of a US recession within a year, when underlying trend payroll gains have eased, corporate profit margins are falling and the yield curve is flirting with inversion. And putting your trust in Trump's (or any politician's) ability to overpower these very fundamental cyclical forces just doesn't seem right to me.

While there is a good deal of pushback on our 2020 forecast, there is a greater degree of agreement on the prospect of lower global trend growth over the longer term. As I have discussed on several earlier occasions, the reversal of globalization has been under way for at least ten years, but Trump has turbo-charged the negative trend with his approach to trade and multilateralism more broadly. And as I have also discussed previously, China's claim to be the new leading champion of multilateralism just doesn't ring right from a global perspective. And as this power vacuum has opened up, can Europe pick up the mantle?

I doubt it, and the latest prospect of additional political uncertainty in Berlin will not help. Now over to Macron in Paris and von der Leyen in Brussels …

And on that note, I shall finish my coffee and walk down along the Spree to see if the light is on this grey Sunday at the chancellery.

Best

Erik

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