Sunday Wrap

Happy Sunday,

First of all, belated Happy 4th of July to all my American friends and readers. Your country is admired across the world, also in these testing times when we struggle to understand what your government is doing to your country – and to the world.

In better news, this past week's two-day joint EIB-ESM Capital Markets Seminar concluded – among other things – that "Europe is surprising on the positive side in this crisis, from the monetary to the fiscal response" (in the words of the ESM's Kalin Anev Janse summarizing the macro panel I was on). It's been a while since one could find such consensus. And, maybe even better, referring to the European Commission's proposal of a mega-sized recovery fund, a panelist from a major US bank argued that this new European vision promises good things for European investment and growth.

I share these views, but I'll take it a step further. Specifically, in today's note:

- **I'll remind you of why Europe has been an excellent place to live, work and invest for the past many years.**
- **I'll argue – with examples from just this past week – that the global environment has become very troublesome as the US has become a global disrupter rather than global leader, and as China and Russia are playing increasingly dangerous games in the vacuum.**
- **Europe needs to react to this increasingly anarchistic world, and the good news is that's what's happening now under German and French leadership. I'll sketch the way through the next few months' big decisions and argue that the prospect for investment and growth is, indeed, pretty good.**

1. A reminder of why Europe has been an excellent place to live, work and invest for the past several decades.

If you are a regular reader of my notes, you'll know that I have never shared the doubts about Europe as a great place to live, work and invest. Of course, I recognize the many issues, weaknesses and complexities facing Europe, but I challenge you to name a better place or time to live for the vast majority of a population during these past few decades in terms of health and life expectancy, material living standards and opportunities, as well as freedom and human rights.

I'll be brief but consider this: As a decent proxy for health and personal well-being, on UN data, Europe takes 20 of the top-30 spots on the global list of life expectancy. The US is number 46, China 64, Russia 112. In terms of per capita income, which is not only the key determinant of people's average material living standard, but also the driver of total equity returns for investors, on IMF data, Europe takes 18 of the top-30 spots. The US is number 10, Russia is 50 and China 67. Moreover, with a much less skewed income distribution than in the US, European per capita income is higher than in the US for almost 90% of the population.

And your chance of doing better than the previous generation is a whole lot greater for Europeans than for Americans (or virtually anyone else). According to the World Economic Forum's Global Social Mobility Index, Europe takes 23 of the top-30 spots, including every one of the top-13 spots, while the US is number 27, Russia is 39 and China 45. In its report from February, the WEF calculates that global GDP could be boosted by a whopping 4.4% cumulatively by 2030 if all countries could raise their social mobility index by 10pp. To illustrate, Germany and France (in 11th and 12th place) are 6.4pp and 8.5pp behind the world's most socially mobile country (my native Denmark - and I thank Danish society for my luck), while the US is 14.8pp behind. The WEF report is here, in case of interest: https://www.visualcapitalist.com/ranked-the-social-mobility-of-82-countries/

Of course, when it comes to the issue of a “vision”, the European narrative has long been overshadowed by the constant calls for reforms, implying a system that fundamentally doesn’t work and needs more adjustment than other economies. I beg to differ, as per above, which is not to say that nothing can be improved. More importantly, however, the world is now changing in a way that is dangerous for Europe, and for our way of life. This, more than anything else, calls for “a new Europe”.

2. A stunning set of examples of global miseries – from just this past week.

As I have discussed in various forms during these past three years – really, ever since the election of Donald Trump - this increasingly troublesome global environment poses a serious threat to Europe, which ultimately can be met only by greater integration, both politically and economically, to boost growth and cohesion across the Continent.

As I’m sure you have noted, Trump’s “America First” agenda ranges from the pitiful to the seriously disruptive – and counter-productive - policy measures, but virtually all serving to withdraw the US from its global leadership role and anchor for the democratic part of the globe. This past week, as the pandemic accelerated across the US, rather than imposing lockdowns and social distancing measures, Trump proudly announced that his administration had bought almost the entire world’s 3-month supply of Remdesivir (the antiviral medication which is being tested as treatment for COVID-19). The week before, the US announced a round of planned tariffs on EU and UK imports, and threatened addition tariffs if the EU (and France) goes ahead with digital taxation. And Trump touted – again - his trade deal with China as a great accomplishment, ignoring the fact that US non-petrol goods export to China has dropped dramatically since his arrival in the White House, and is now set to reach the its lowest level since 2010.

I’m not arguing that Trump’s presidency alone has led to all the backsliding in global governance and cooperation, but the coincidence is rather stunning. Not surprisingly, it’s no secret that both China and Russia hope for his re-election - while Europe (with very few exceptions) don’t.

For example, two years ago, China changed its constitution to allow President Xi to remain president for life, if he so wishes, and to include “Xi’s thoughts” as an explicit part of the constitution. Xi’s vision of China in the world has been clear for some time, from the spreading of Chinese influence via the Road and Belt Initiative to Chinese activities in the South China Sea.

And just this past Tuesday, China passed legislation that criminalizes a whole bunch of acts for people in Hong Kong, including secession, subversion, terrorism and collusion with foreign powers, with punishment of up to life in prison, including via trials in mainland China and non-public ones. On paper, outlawing terrorism seems reasonable enough, but the new Chinese definition of terrorism seems rather extreme to me. For example, vandalism of subway cars is now reportedly being characterized as “terrorism”, and already on Wednesday, a reported ten people were detained in Hong Kong under the new law, one apparently for carrying a pro-independence flag.

I noted the rally in Chinese stocks to new record highs on Friday, but I still wonder how Western investors (increasingly being asked by their stakeholders to consider social responsibility when deciding on their portfolio) relate to such developments, not least when I read the public statements of support for this new Chinese law by several international companies, including HSBC, Standard Chartered and Jardine Matheson Holdings.

In addition to the issues related directly to human rights, this change in Chinese law violates – as far as I understand - the 23-year old handover agreement with the UK. As a result, the UK has replied by offering residency, and a path to UK citizenship, to the roughly three million Hong Kong residents who have – or are eligible for – “UK Overseas passports”, an offer that was met with warnings of unspecified consequences by China. And in Washington, Congress passed a bill and sent it to Trump for his signature, placing sanctions on Chinese officials involved and on companies doing business with them.

Also this past week, Russia concluded its multi-day referendum on a new constitution, which was approved by 78%, thereby resetting Putin’s presidency so that he can remain president until 2036, if he so wishes (quite a parallel to China, although “Putin’s thoughts” wasn’t included in the new constitution). With heavy state-sponsored propaganda and no independent observers, there was, of course, never any doubt about the outcome.

Putin's vision of Russia's role in the world has also been on vivid display in recent years (and is well documented in Catherine Belton's excellent book "Putin and his people" from earlier this year), from the annexation of Crimea (violating the 1994 Budapest Memorandum on Security Assurances, which Putin himself signed), to the military involvement in the Middle East as well as documented interferences in US and European elections. This past week, it was revealed in a US Intelligence report that Russia has offered a bounty on US troops killed in Afghanistan.

3. The new European vision.

As the world is turning increasingly anarchistic, it ought to be clear to everyone that Europe needs to integrate economically and politically to a greater extent – to play a constructive role in this troublesome world (or, at least, not to be taken advantage of), ultimately, to generate stronger, more sustainable, and better distributed growth.

This recognition had certainly become clear in many parts of Europe in recent years, but until the beginning of this year it was predominantly a call for action by French President Macron, and, more recently and to a lesser extent, by German Finance Minister Scholz. But then came the devastation of the pandemic, particularly in Southern Europe, which triggered what surely must have been brewing in Merkel's mind for a few years, namely a clear U-turn in Germany's Europe policy. In case you missed it, Merkel lays out her view of the world and Europe in this interview in six European newspapers last week – here the English version in The Guardian: 'For Europe to survive, its economy needs to survive': Angela Merkel interview in full

The vision of the appropriate European response, as she articulated along with Macron, is well known and has now become the cornerstone of the European Commission's proposal of a EUR 750bn recovery fund with bells and whistles on top of the proposed EUR 1.1 trillion Multi-Annual Financial Framework (MFF).

And it all comes together to get negotiated and agreed on during the German EU presidency, which started this past Wednesday.

Normally, the EU presidency is relatively inconsequential, but not this time. During the second half of 2020, Europe will indeed be making some of the most important decisions in the Union's history, and Germany – in addition to being the EU's primary paymaster – is now also the co-author of the new vision for Europe as well as the arbiter of negotiations among EU-27 to agree on this plan – as well as a host of other important issues.

The German government has published a 28-page program with their broadly defined ambitions, titled "Together for Europe's recovery" in which they identify six guiding principles for their presidency, namely: (i) overcoming the COVID-19 pandemic permanently, as well as the economic recovery, (ii) a stronger and more innovative Europe, (iii) a fair Europe, (iv) a sustainable Europe, (v) a Europe of security and common values, and (vi) a strong Europe in the world. It's good, if rather general, read and here, in case of interest Together for Europe's recovery

More concretely, the task will be to get the Recovery Fund and MFF approved, save the Brits from themselves, i.e., get a Brexit deal, and getting the Banking and Capital Markets Union back on track.

If you wonder about the German government's relative priorities, this past week's ARD opinion poll, which asked Germans what they think should be their government's priority for their EU presidency, may serve as a guide: 50% of Germans identified policies to battle climate change as the highest priority, 39% said the consequences of the pandemic, 33% said maintaining the "rule of law" in the EU as top priority, 25% called for digitalization, 24% prioritized the future of EU finances, and (illustrating how the usually very anglophile Germans have given up on the UK) just 7% ranked relations with the UK as top priority.

In a nutshell, Germans' (and Europeans' more broadly) very high priorities to halt climate change and to promote digitalization are rooted in a widespread belief in science (which has been further enhanced with the pandemic and the visible consequences in countries where the leadership questions the discipline), and an acknowledgement that the digital revolution was based in the US – and rapidly copied, and further developed, by Chinese state-sponsored companies. For some years, Europe seemed content with the role of buying the technology from these competing sources and applying it to European products and everyday life. This, however, has now changed.

The EUR 750bn mega package, the MFF and the policy changes to prioritize climate change and digitalization, all come together in one deal, which will be negotiated by the European Council later this month and – very likely –be agreed on before the end of Q3.

I'll touch on two aspects of the deal.

First, the obstacle to get it agreed on. The most vocal opponents are the so-called "Frugal Four" (the Netherlands, Sweden, Austria and Denmark), although Denmark has softened its opposition, and other small Northern Europeans have joined, including Ireland. In particular, Dutch PM Rutte has been very vocal in his opposition to grants (versus loans).

Here is what needs to be said to Rutte, as well as to the new Irish PM, should he join the opposition to the package: Before talking about European fiscal rules, we need to talk about fiscal policy in some of these Northern European countries, and particularly about their tax haven policies towards global corporate firms, which encourages the shifting of tax payments between countries, irrespective of where the actual activity takes place.

For example, in their paper from April this year, some of the world's leading academic experts on tax haven issues, Tørslev, Wier and Zucman, show the extent of misallocated corporate tax revenues inside the OECD due to tax haven structures. The biggest losers inside the eurozone include Germany (USD 55bn equivalent in lost corporate tax revenue directed to other OECD countries in 2015 alone), France (USD 32bn), and Italy (USD 23bn), while the biggest beneficiaries of such structures include Ireland (USD 106bn), the Netherlands (USD 57bn) and Luxembourg (USD 47bn). How this is acceptable inside a currency union (or anywhere among partner countries for that matter) beats me. Their paper "The missing profits of nations", 22 April 2020, is here: http://gabriel-zucman.eu/files/TWZ2020.pdf

So, will a compromise be an ugly deal to tone down the original Macron-Merkel plan of a road to a common European corporate tax regime to level the playing field, or will the Dutch and other "frugals" begin to appreciate that the package is not a zero-sum game, and that they should not sign on to it out of charity, but out of self-interest. I'm sure they don't need reminding that the US did not hand out money under the Marshall Plan out of pity or charity, but to help build a stronger Europe that would anchor the continent and the UK as US allies, rather than allies of anyone else. The same could surely be said about Europe today, given the global environment, and the only question the small Northern European countries need to ask themselves is whether they'll be part of the solution, or whether they think they can (or should be) free-riders, as Germany and France lead the way – while maintaining their benefits from the Single Market and European stability?

Second, a group of opponents, including Sweden and Denmark, would likely accept a more constructive policy adjustment (tan promises of continued tax haven status) as the "price" for their support, namely a further beefing up of Europe's green commitment. This will be relatively easy for Germany (see opinion polls above) and France (see outcome of this past week's local elections) to agree to.

The green agenda will need to have two components. Relative prices need to be changed in favor of renewables and sustainable economic activity and away from pollutants. A first important step in this direction will have to be a carbon tax – and a message that it'll be increased regularly in coming years. This will have important socio-economic impacts, hurting mostly the less well off, living away from the cities. Therefore, the revenue from such taxation will have to be channeled back to this part of the population, partly as incentives to change to a more sustainable way of living, partly – probably – as straight transfers.

The green agenda will also need a massive boost in public investment – and there is enormous scope for this. Net public investment in Europe dropped from 1.0%-1.5% of GDP per year in the 1980s (at par with the US), but it then dropped below 1% from the mid-1990s, only to be completely killed off to roughly zero (even at times negative numbers in parts of the eurozone) as "austerity" became the religion after the great financial crisis. As I have argued before, in my assessment, European public investment should be boosted by at least 1%-2% of GDP, and education spending by maybe 1% of GDP – and debt-financing it at around zero percent interest rates sets the bar for good investments rather low...

In addition to a big boost to public investment, private investment will need to be encouraged. Net private investment amounted to 5%-6% of GDP per year during the years until the great financing crisis (again, at par with the US), but they have dropped to 2%-3% of GDP since then (while the US has recovered better).

Private investments are driven predominantly by companies' trust in demand for their products relative to the degree of spare capacity, the degree of certainty they assign to their forecast of demand, and the availability of financing, including retained earnings and the cost of external funding. With Europe now about to agree on a "philosophical shift" in policies (in Macron's words), a vision – of green and digital priorities – will become clearer, underpinned by a sizable boost to public investment.

In other words, the increasing degree of global uncertainty is likely to be mitigated by a greater degree of "European certainty". Up against this, however, is the fact that the crisis will have left corporates with additional debt and – if history is a guide – therefore with an urge to deleverage. The answer to this is a fast route to a fully-fledged banking and capital markets union, which encourages (via taxation and regulation) equity over debt. In addition, better tax incentives to invest, e.g. via rules for deductions, should also be considered.

I have written about this before, and – I feel – my time is up when it comes to occupying your Sunday afternoon, so I'll leave it like this for today.

And with that, I wish you a continued good weekend, and with the hope that "good old America" will soon return, I leave you with the Japanese ambassador to the US, Yamanouchi Kanji's, very cool Jimi Hendrix inspired rendition of the Star Spangled Banner. If in doubt, it reminds us all that the world is still a beautiful place:
https://twitter.com/tripperhead/status/1279281700673949696?s=11

Best,

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