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Macroeconomic Comment

Global Economy Under the Spell of Government Support Programs

October 10, 2020, Peter von Elten

Government support programs and an extremely expansive monetary policy continue to dominate the current economic trend. Only once the state subsidies phased-out and economies resume more market-based structures, will it be possible to assess more reliably the impact of the pandemic on the future course of the economy. Only then will the development of corporate debt, the volume and severity of bankruptcies, and their impact on the banking system become visible. It will be decisive as to how quickly unemployment will fall and how strongly government tax revenues will recover, which most likely are to be offset by significantly higher social costs.

The importance of government debt, which is likely to have risen by 15% to 20% worldwide by the end of this year, is receding into the background because, as a result of the ongoing zero or negative interest rate policy, the debt sustainability has improved, at least relative to the volume, but also in absolute terms due to more favorable refinancing terms. In the fight against the pandemic, there continues to be broad agreement that extraordinary state aid and intervention, accompanied by higher government debt, were and still are absolutely necessary. Recently, FED President Powell (doing too little is much worse than doing too much), ECB President Lagarde and Carmen Reinhart, Chief Economist of the World Bank, urged the industrialized countries to adopt additional stimulus programs and accept rising public debt as the lesser of two evils. Reinhart considers a coming credit crisis to be very likely. Recent studies show that lending standards have already become much stricter. Deutsche Bank recently informed its customers that the risk of financial distortions due to the overvaluation of tangible assets has increased significantly in the face of growing debt.

China and a number of Asian countries have coped well with the pandemic. China will show positive growth in 2020, while the gross domestic product in European countries will decrease by between 5% and 11% this year. While stock markets in many countries are back to levels seen at the beginning of the year, forecasts for unemployment and weak productivity growth indicate that the level of global economic activity in 2019 will not be reached until the end of 2022 at the earliest, and even much later in other sectors such as tourism and culture. The OECD predicts an unemployment rate of 9.4% for the 37 OECD countries as a whole at the end of 2020 - compared with 5.3% at the end of 2019. According to the OECD, even strong growth in the coming year

would still leave a higher base of unemployed people, partly because many companies will have taken advantage of the crisis to streamline their workforce.

As expected, the surge in economic activity following the shutdown has enabled a rapid recovery. However, the expiration of catch-up effects, the successive reduction of many fiscal stimulus measures and a new wave of viral diseases are jeopardizing the pace of further upswing. Nevertheless, the markets assume that the Governments will take further stimulus measures if the second wave intensifies. This approach appears to be just as "without alternative" as keeping high equity ratios in times of low or negative interest rates, when exuberant liquidity is seeking high-yielding investments.

USA – An Erratic President Who Could Refuse the "Concession Speech" Because of Alleged Election Fraud

Democrats and Republicans agree that a further program to support and stimulate the economy is necessary following a package of the $3 trillion in government aid approved in March, the so-called CARES Act, which expired at the end of July. Nearly 25 million Americans received $600 per week on top of the usual $330 per week average state unemployment benefits through the emergency program, often leaving them with more in their pockets than during former employment. In the meantime, the two parties had come much closer together. In the House of Representatives, the Democrats had pushed through an already reduced program of $2.2 trillion, but it did not stand a chance in the Senate against the majority of the Republicans. The government had accommodated the Democrats with an increased package of $1.6 billion until President Trump stopped further negotiations. Among the points of contention were the Democrats' demand for state and municipal aid of over $900 billion and the extension of the weekly supplementary payments for the unemployed to the previous level of $600 per week.

The September employment report, the last before the elections on November 3, showed that about half of the 22 million jobs lost in April and May have now been regained. The unemployment rate declined from 8.4% to 7.9% in September and the underemployment rate also declined but is still above 13%. The number of American citizens who have definitively left the labor market has risen to 700,000, which puts the already slowed recovery in the labor market into perspective.

A survey of American companies has shown that less than 4% are willing to relocate part of their production back to the USA. Despite all the tariffs, delivery bans and threats, the Trump Administration has not yet succeeded in reducing the trade deficit overall and specifically with China. In

August, the trade deficit reached $67 billion, the highest level in 14 years. In the first 8 months, the trade deficit was almost 6% higher than in the same period last year.

Observers of the U.S. election campaign expect Trump to come up with another surprise to get voters behind him, be it a verbal or military armament against Iran or China/Hong Kong. The approval of a vaccine before the elections, as demanded by Trump in order to distract from the mismanagement in the fight against the virus, will hardly succeed. The offer to all Americans to distribute free of charge the medication that Trump has received in fighting the virus is likely to be seen as an obvious, if not cynical attempt to win back voters he has lost by downplaying the virus threat. Currently, challenger Biden is leading the polls by more than 10%. So far, no presidential candidate in America has managed to catch up more than 5% in the last four weeks of presidential election. It should be noted, however, that many voters consider the policies of the current administration to be good, but do not want to publicly declare their support for Trump. Thus, polls could give a false impression.

China – Economically Successful, Politically Increasingly Isolated

In coping with the pandemic, China and other Asian countries such as Taiwan, Hong Kong, South Korea and Vietnam have so far been much more successful than the USA and Europe. China sees the management of the pandemic and the rapid economic recovery as a demonstration of the superiority of Chinese socialism over Western democracies. Economic success may well have encouraged China to take a more aggressive geopolitical stance, leading to China's growing isolation on the world political stage. After China's military intervention in the Kashmir region, India turned away and resorted to boycott measures. Western countries condemn China for its greater influence on Hong Kong through the so-called "Security Treaty", which violates the Basic Treaty between China and Great Britain. Threatening gestures toward Taiwan and China's expansion of power in the South China Sea are further evidence of an expansionist policy.

Stock market and currency developments underline that China has become an attractive market for international investors despite all political reservations. This is reflected in the growing popularity of "policy bank bonds". In the first eight months of this year, foreign investors bought such bonds in the equivalent of $44 billion issued by either the China Development Bank, the Agricultural Development Bank of China or the Export-Import Bank of China. In China, this is also seen as a sign that international investors have become acquainted with the Chinese credit market.

Europe – A Big Step Towards a Transfer Union

The budgetary discipline enforced by the Maastricht criteria and by debt brakes, which have been blamed for the weak growth in the EU over the last few years, is a thing of the past and will probably not be able to be enforced anymore in its present form even after the pandemic has ended. In the wake of the fight against the pandemic, countries such as Italy, France and Germany have increased their national debt massively, decoupled from the grip of the austerity policy that had shaped Europe for years. In addition, there are programs at the EU level of over € 500 billion and the so-called reconstruction program of € 750 billion, which for the first time enables the EU to take on large amounts of debt in its own name and to provide non-repayable grants on a large scale. In my view, this debt pooling, which many European countries have long been calling for, is an irreversible step towards a European transfer union. In order to achieve the necessary unanimity of the 27 EU countries, the massive borrowing at EU level was described as a one-off operation and repayment of this 750 billion euros was agreed in accordance with the quotas set by the 27 countries over the next 30 years. As with the softening of the "no bail-out" clause enshrined in the EU Treaty, the turning back of the wheel in debt policy is unlikely.

The constitutional obligation for unanimity of all member states on important decisions is a serious constructional flaw that often paralyzes the EU and makes it susceptible to blackmail. This leads to protracted negotiations and expensive compromises, as is now the case with the implementation of the € 750 billion reconstruction program. The smaller countries enjoy a disproportionately large influence that they are not prepared to give up, sending the long-requested reform of the voting system for majority voting down the road.

Massive new debt at various levels should give a significant boost to the European economy over the next two years, just as the tax reform in America has done. The longer-term developments will depend on whether the money is used as planned to modernize and strengthen Europe's competitiveness. The highest subsidies from the reconstruction program will go to Italy and Spain, two countries with unstable political constellations in which consumption rather than reform could become the focus of attention.

Brexit – More Than Four Years of Suspense Come to an End

More than four years ago, the British people decided to leave the EU in a close vote and under partly untrue premises. Since then, the country has gone through several political crises. To this

day, the economy lacks any planning certainty as to how an agreement between the UK and the EU, which should be ready by the end of this year, will ultimately be structured. This has restricted investment by domestic and foreign companies, slowing down the previously robust growth and reducing the productive capacity of the British economy. The UK ranks fifth in the ranking of the largest countries in terms of GDP, with the equivalent of over €2.5 trillion, but only 29th in the world with a per capita income of around €35,000 per capita, adjusted for purchasing power.

In the last ten years, the UK has pursued an austerity policy that has kept the national debt stable at about 85%. Official British sources forecast a budget deficit of the equivalent of €245 billion in 2020 and an increase in government debt to over 100%. The pandemic has hit the UK harder than any other European country; the health service has been overburdened, leading to a high excess mortality rate.

Even after the conclusion of negotiations with the EU, Prime Minister Johnson still faces some challenges. The government's promise to preserve at all costs the hard-won peace between Northern Ireland and Ireland, which was achieved with the so-called Good Friday Agreement of 1998, and to avoid a hard border between the two countries, can hardly be fulfilled satisfactorily as long as Ireland remains a member of the EU, which runs counter to an open border. Furthermore, Scotland had also spoken out in favor of remaining in the EU and wants to hold a second referendum on independence from Great Britain.

Conclusion

Support programs of unprecedented magnitude, together with ultra-light monetary policy, have helped to keep the damage of the pandemic to the global economy under control. The exit from the state-controlled economy back to market-dominated structures is fraught with many uncertainties that make reliable growth forecasts almost impossible at present. Especially since a second wave of the virus has set in in Europe, various support programs are coming to an end and the catch-up demand should be largely covered. Positive market impulses might come from the approval of a vaccine, the outcome of the US election, the agreement on a second major support package in the US and the outcome of the Brexit negotiations. Although fundamental data suggests caution, markets will probably continue to benefit from the determination of central banks and politicians to use all available means to contain the crisis.

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He holds various board mandates and was previously a member of the board of directors of Fortune Wealth Management AG, Zurich. Prior to that, he was General Manager of Schroder & Co Bank AG, Zurich, from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

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