Global Imbalances Redux ?

85 – 29 March 2021

Due to the Easter bank holiday, the next Macrocast will be published on 12 April.

Key points

- We don't think Europe can easily emulate the US and engage in a massive fiscal stimulus. More emerging countries are hitting the limits of their policy space. This is consistent with a rising current account deficit in the US and the revival of the "global imbalances" theme. We remain confident in the strength of the dollar though.

Joe Biden's fiscal stimulus is likely to trigger some envy in the rest of the world and particularly in Europe, especially when its impact will combine with the faster reopening of the US economy to deliver what could be a spectacular mid-year 2021. We think the chances of the EU emulating the US and rapidly upgrading the Recovery and Resilience Fund are slim though. Political complications abound for now, and assuming they can be resolved by this autumn, the likely post-reopening rebound will in any case reduce the appetite for another round. The best we can expect on this front is an acceleration of the already committed disbursements.

True, national governments could "take the matter in their own hands" but we don't expect much beyond the extension of the emergency support schemes, which lack the confidence-boosting, attention-grabbing nature of the US package. Doubts about the quantum of support from the European Central Bank (ECB) beyond March 2022, as the debate between "absolutists" and "relativists" is getting rife at the central bank's board, may make governments cautious about deteriorating further their debt trajectory.

Meanwhile, in emerging markets, the list of countries forced into a monetary tightening is getting longer, with Brazil and Russia joining Turkey. Their contribution to world demand in 2021 may be dampened as their capacity to spur domestic spending is being hampered. True, China continues to do well, but Beijing is cautious not to engage in "over-stimulus". Between the Euro area's difficulties with the pandemic and policy constraints becoming more apparent in EM, the US looks like quite isolated as a lone candidate for overheating this year.

This is consistent with the US current account deficit rising, and we have started seeing the "dollar bears" congregate around the notion of "twin deficit" to revive the "global imbalances" storyline and predict a depreciation of the US currency. Still, the sensitivity of the US current account to the cycle is significant but not spectacular. We think the growth and interest rate differentials will offset much of the concerns over the external position of the US and we remain confident in the strength of the dollar.

Stimulus envy

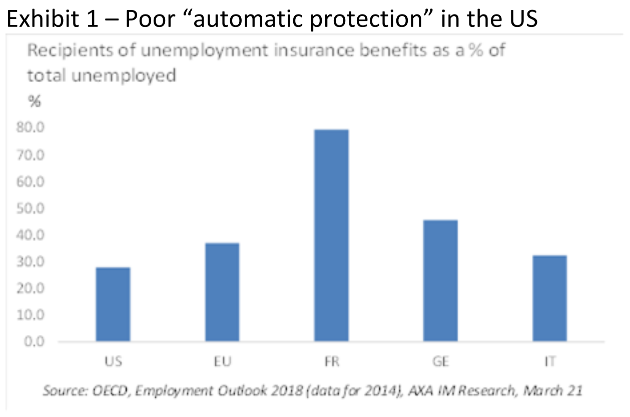
We suspect that Biden's massive emergency fiscal stimulus, combined with the discussions on the USD3trn investment plan, will trigger some envy in other countries. The current situation in the Euro area possibly justifies a large-scale fiscal push more than in the United States. Arguably, at least some of the emergency package in the US is "overkill" given the imminent reopening of the economy there – it is already well underway in some states - while in the Euro area the likeliest path for the next few months is an intensification of the restrictions, given the relentless acceleration in the pandemic in several countries contrasting with the slow pace of vaccinations. We are not holding our breath though for a spectacular package at the European level.

The Recovery and Resilience Fund has created a "division of labour" between the national governments and the EU-level fiscal response. The capitals provide the "run-of-the-mill" immediate support to their economy, keeping the private sector afloat thanks to loan guarantees and part-time unemployment benefits, while Brussels funds the "forward-looking" component, the investment programme which is designed to offset the long-term adverse effects of the pandemic effect on productivity and potential growth. This is rational in terms of financial risk distribution. The "run-of-the-mill" support is by construction temporary. While it deteriorates the fiscal position of the member states for the duration of the crisis, it should not have a lasting impact on the *structural* component of their financial balance, especially if this temporary splurge is funded at negative real interest rates. The impact on national debt sustainability conditions is thus minimal. Conversely, the investment programme has a longer horizon and entails some structural expenditure. Even if ultimately, it could "pay for itself" by boosting trend GDP growth in the recipient countries, it makes sense to mutualize the corresponding debt so that the most fragile member states do not face long-term debt sustainability questions.

A natural consequence of this division of labour is that, faced with a prolongation of the restrictions, national governments merely respond with a time extension in the emergency support programmes In effect, this will trigger a deterioration in their fiscal deficits beyond the mechanical effect of lower-than-expected growth on tax receipts, but a key difference with the US approach is that these extensions are increasingly seen as "natural" by public opinion – when they are perceived at all - without the spectacular, confidence-boosting effect the US emergency package is having.

To some extent, the contrast between the US and the Euro area is an "optical illusion". Indeed, **US packages are spectacular because they have to offset the weakness of the automatic stabilizers**. This is a well-worn argument, but we want here to show in a concrete manner how safety nets cushioning temporary shocks differ across the Atlantic. The OECD calculated that in 2014 – a "normal year" from a cyclical point of view – only 28% of unemployed people in the US were effectively covered by unemployment insurance benefits (the system is notoriously cumbersome and extremely restrictive in coverage in many states), against 37% on average in the EU and nearly 80% in France (see Exhibit 1). These structural flaws force Congress to pass massive discretionary packages in bad times. In Europe the mere extension of existing schemes already brings some significant support.

Exhibit 1 – Poor "automatic protection" in the US



It would be wrong however to consider that larger automatic stabilizers make medium-term help useless. Indeed, in principle, since every delay in the normalization of the economy raises the probability of severe hysteresis effects in Europe further dampening its growth potential, then long-term fiscal support would be warranted, and the EU-wide Recovery and Resilience Fund should be upgraded. But this is likely to hit some significant political hurdles.

Thorny political and sequencing issues

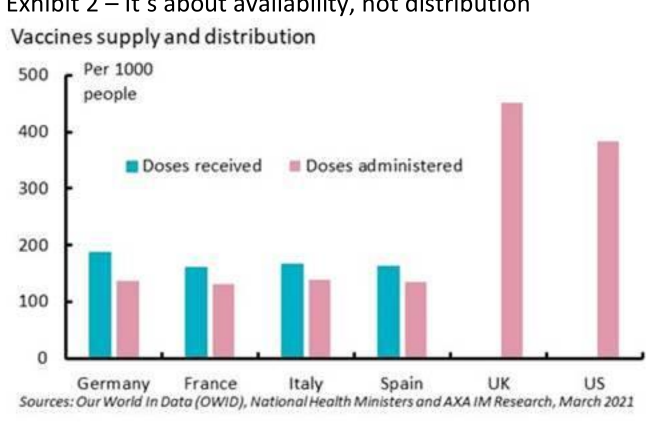
Last year, the "frugals" only reluctantly accepted the principle of debt mutualisation. An increase in the size of the package agreed last year would probably be resisted. True, the recent general elections in the Netherlands – leading the "frugal pack" – have been favourable to the most vocally pro-European party within the incumbent coalition (D66). Still, even they may face an uphill struggle in convincing public opinion that another round of EU expenditure is needed while the first one has not even started to be disbursed and national recovery plans have not yet been finalized in many countries, even less so scrutinized by the European Commission.

We would expect the "frugals" to insist on more conditionality on the disbursement of the funds if they were upgraded, which in turn would make it less palatable to the other governments. The French press for instance has been speculating since February on the notion that the European Commission would make the pension reform a condition for its endorsement of the national plan.

Political dynamics in Germany may get in the way as well, at least temporarily. The current RRF has just been endorsed by the Bundestag with a two-third majority, but attitudes across the main parties vary. CDU-CSU is probably the least inclined to get further into debt mutualisation, especially in the run-up to the elections in September. After that, if the Greens make it to the ruling coalition, Germany could become more supportive of an extension of the RRF. The party has issued some ambitious ideas on European matters in their draft manifesto, and their spokesperson on EU affairs stated that their *"mission statement is a European federal Republic"*. Still, until the elections we suspect Berlin will want some peace and quiet on this front, even if Paris and Rome are likely to push.

If the political conditions for an extension in the RRF are not met within the next 6 months, the sense of urgency may have faded by then. Indeed, even though your humble servant has been quite pessimistic on the speed of the European normalization in the first half of 2021, the probability it happens by the autumn is however fairly high. What is in balance is the fate of Q3, since at the current pace of vaccination reaching collective immunity by the summer definitely is a challenge. Still, an acceleration seems possible. The problem in the EU is not of a logistical nature – a difficulty to distribute existing doses.

Exhibit 2 – It's about availability, not distribution



In Exhibit 2 we compare the number of doses received by the healthcare system in the four top economies of the Euro area with the doses which have been effectively inoculated. The largest gap is in Germany, but in general, c.80% of the available doses have been used. In other words, even if a 100% rate had been achieved, continental Europe would still be far behind the US and the UK. The EU is experiencing issues with access to vaccine

production. While Astra Zeneca was expected to provide 17% of the total doses in Q2 – which it is unlikely to be supplied given their internal technical difficulties – Pfizer so far has been able to deliver more than expected, and J&J is being added to the pool. Our point is that the delays in the vaccination programme are probably so big now that avoiding another round of restrictions into Q2 and possibly the beginning of Q3 in most countries is unlikely. Still, "writing off" the second half of the year entirely is in our view exceedingly pessimistic**. If the Euro area starts experiencing a mechanical rebound in the last months of 2020, the immediate pressure to deliver an extra fiscal push will be much lower.**

Even assuming a consensus could be reached, the technicalities of an upgrade of the RRF would make it difficult to believe actual transfers could be made quickly. The national resilience and recovery programmes would have to be revised, re-assessed by the European Commission and endorsed by the European Council. We get back to the main flaw of the scheme: its slow reaction capacity. Possibly, once the euphoria of the mechanical rebound triggered by the reopening and hysteresis effects appear, capping the recovery, the EU can find the wherewithal to extend the RRF. But in the meantime, we suspect national governments will be "on their own" and some of them are likely to be hesitant to add to the already significant deterioration in their public debt trajectory another layer of discretionary support beyond the mere extension of the short-term, emergency schemes.

ECB's "absolutists" versus "relativists"

A thorny sequencing issue is that **national governments** – especially those with an already challenging public debt trajectory – **may hesitate to engage in another significant fiscal push as the quantum of ECB support may become uncertain.**

Two schools of thought seem to emerge at the ECB board, around two board members, Fabio Panetta and Isabel Schnabel. The former led the way on the notion that a large part of the ECB's job under the current circumstances is to make fiscal support financially sustainable. This view is now mainstream at the central bank but from this premise Panetta has developed a sort of absolutist approach to "preserving financial conditions. In his view, the constellation of interest rates and credit standards at it was in December 2020, when the ECB last altered its policy stance, should be the reference. Conversely, Isabel Schnabel outlined a "relativist" strategy in a speech last week. The central assertion in her piece is the following: *"an increase in real interest rates is not necessarily a sign that financing conditions are becoming less favourable. For example, as the economy recovers, real and nominal long-term rates will gradually rise in tandem with the real equilibrium rate".* She went on to offer some details as to how the ECB could assess the benign nature of a rise in real rates: *"if stock markets increase and credit spreads tighten in response to a rise in real interest rates, markets are likely to price in a stronger growth outlook that could leave financing conditions favourable".*

A key issue for us with this "relativist" approach is the time horizon of the assessment. We have already discussed in Macrocast how the markets are forward-looking, but also short-sighted. It is likely that the markets will react very positively to the reopening of the European economies when finally collective immunity is reached on this side of the Atlantic. Real rates will move up, and so should equity prices, while the reduction in the probability of corporate default would tighten corporate spreads. This may not last very long though, if after the mechanical rebound the Euro area reverts to a mediocre growth rate as the "scarring effects" of the pandemic crisis would start showing. Yet, the ECB may have turned the tap off its own extraordinarily supportive monetary stimulus by then.

A careful consideration of the macroeconomic outlook – with a particular focus on the inflation trajectory – before making any decision on how to respond to a tightening in real rate is among the qualifiers Isabel Schnabel added to her relativist approach. Hopefully the ECB would be able to be forward-looking and disregard any short-lived improvement in the data, but **by 2022 the central bank will have less space for fine-tuning and more binary decisions will have to be made.** The biggest one is whether to extend the Pandemic Emergency Purchase Programme (PEPP) beyond March 2022. Even if the economy is mediocre, but the Euro area is "Covid free", it will be difficult to continue with PEPP. The central bank is likely to avoid a "cliff" and we would expect some sustained Asset Purchase Programme (APP), its "normal" quantitative easing instrument, to be announced, but the overall

quantum of ECB purchases would be likely to fall anyway. This could coincide with the Fed being well-engaged in its "tapering", consistent with another rise in US long-term yields. The level of protection from US contagion onto the European bond market may be limited.

Of course, all these considerations will be factored in by the ECB in due course, but as we get to the end of 2021/beginning of 2022, we think it is more likely than not that Euro area governments would hesitate to engage in long-term fiscal projects without being shielded by the EU budget.

Policy space shrinking in (some) emerging markets

For quite some time in Macrocast we have been concerned with the possibility that **policymakers in emerging markets start facing a conflict of objectives forcing them to embark on policy tightening** before their economy have truly exited from the brunt of the Covid crisis. Rising inflation, either as a direct consequence of the domestic stimulus or a side-effect of currency depreciation in reaction to the rise in US yields, is affecting the monetary policy stance.

Turkey was the "canary in the coalmine" from this point of view, and Ankara has moved to yet another phase. While the intentions of the new governor of the central bank are not clear at this stage, his past writings suggest he may have been appointed to stop the recent rate hikes spree. The country is between a rock and a hard place. The lagged effect of the monetary tightening combined with the impact of rising inflation and a deterioration in the financial position of Turkish corporates which have to face a massive "currency mismatch" issue, is likely to trigger a double dip recession.

The central banks of Brazil and Russia have now followed their Turkish counterpart on the tightening path, although the level of interest rates is significantly lower there. In Brazil, the rate hike – the first since 2015 – reflects the intensifying frustration of the central bank with the government's huge fiscal stimulus. It is unclear to us though whether such "warning shot" could alter the fiscal stance. With President Bolsonaro now having to deal with the political resurrection of Lula da Silva ahead of the elections in October 2022, the political feasibility of a fiscal consolidation plan is limited. A lingering conflict between monetary and fiscal policy is unlikely to help protect Brazil's contribution to world demand. Either the "central bank wins", and domestic demand is dampened, or the "government wins", and the currency falls – and hence Brazil's purchasing power over the rest of the world.

Of course, these issues are manageable as long as the EM juggernaut, China, continues to perform well, and the dataflow there remains reassuring, but **policymakers in Beijing continue to shun "over-stimulus**". The bar for the 2021 GDP growth target (above 6%) announced at National People Congress is low by Chinese standards. The focus on the quality of growth and a reluctance to rekindle financial stability issues continue to dominate.

US current account deficit to rise – but not necessarily that much

If the Euro area is unlikely to come up with a significant additional stimulus and increasingly emerging markets outside China are facing constraints on their policy space, it is likely that **this year the US could come out as a fairly isolated "strong story"**. Strong fiscally supported domestic demand and constrained world demand is a combination consistent with a higher current account deficit, and dollar-bears have seized on this issue to see the current strength of the US dollar as short-lived.

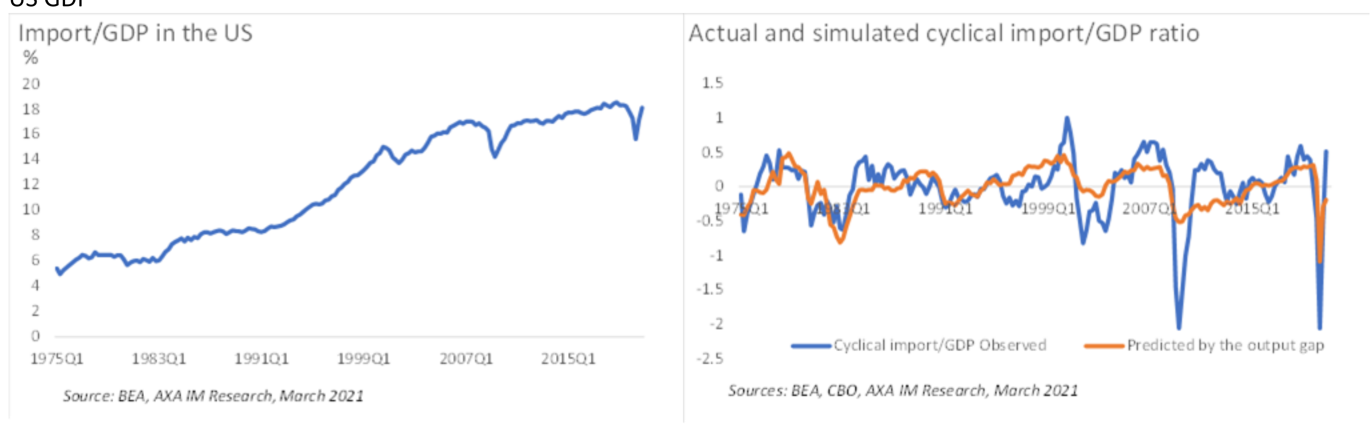
While we agree the current account deficit will likely rise, it might not be as spectacular as some observers predict. We focus on the imports to GDP ratio side of the current account. As can be plainly seen in Exhibit 3, this ratio has increased on trend over the last 40 years, with a massive acceleration in the 1990s (which coincides with the creation of NAFTA), reflecting the overall globalization of supply-chains. Of course, beyond those structural forces cyclical conditions affect import dynamics. In an "overheating phase", we would expect imports to rise as a percentage of GDP because i) domestic suppliers face difficulties meeting demand and ii) investment tends to be very strong at the top of the cycle, and the import content of capital goods is high. To quantify this, we regressed the de-trended value of the import to GDP ratio (in practice we have run the variable through a Hodrick-Prescott

filter) on the output gap of the US economy estimated by the Congressional Budget Office. The model has a decent fit (see Exhibit 4). The elasticity we find is 0.13. In other words, **for the imports to GDP ratio to rise by 1% of GDP** – and hence the current account deficit if we take the extreme view that world demand would be so depressed that the US export to GDP ratio would not improve – **the output gap would need to improve by nearly 8% of GDP**. It would take a very extreme view of the power of the Biden package to get us there.

Exhibit 4 provides another interesting observation: the import to GDP ratio in Q4 2020 is already higher that what the model would predict (by 0.7% of GDP). This probably reflects the fact that the pandemic is having a disproportionate impact on the non-tradable part of the economy, particularly personal services, while consumption of goods – with a high import content – has held up much better. We would expect the acceleration in the economy as the US reopens and is further supported by the Biden package to lift services primarily, with limited traction on foreign suppliers.

Exhibit 3 – Structural forces have lifted the import content of US GDP

Exhibit 4 – How sensitive is it to cyclical conditions?



In any case the rise in the current account deficit may not last too long. It remains to be seen if Biden's emergency package will be followed by the investment programme, while ultimately European demand will re-start, supporting the US export side. In the meantime, the strong growth and interest rate differential should sustain the attractiveness of the dollar, even if we are bracing ourselves for a flurry of market discussion on the re-emergence of the "twin deficits".

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• Personal income retreated 7.1% in Feb following Jan's +10.1%, spending -1.0% • PCE deflator rose to 1.6% in Feb as expected, but 'core' slipped to 1.4% (from 1.5%) • 10-year UST yields retraced, <1.60% at lows, real yield component softened, BEI edged up • Fed speakers out in force stressing patient response to expected strong rebound • Home sales fell sharply on Feb weather	• President Biden speech in Pittsburgh to provide details of planned infrastructure package, likely aspirational for now • Jobless claims, following a sharper than expected drop last week to 684k (3.87m) • Employment report expected to point to bumper jobs gain in March as activity picks up • ISM manufacturing index expected to remain solid
Euro Area	• Germany to increase its 2021 net funding target to €240bn (+€60bn) • Confidence data were pretty strong: sharp rebound in services confidence in France, improvement in consumer confidence in Germany, EA PMIs at an 8-month high • Flows of loans to NFCs positively improved	• EA March flash inflation to be in the spotlight, expect core at 1% and headline at 1.2%yoy • EC survey to echo PMIs and improve in March- but sample period will be important (biased if it happens before tightening of restrictions) • Check for pick-up in vaccination pace
UK	• CPI inflation dropped to 0.4% y/y in Feb from 0.7%, with changed seasonal affecting clothing • Employment -147k (3m to Jan), but unemp dips to 5.0% - still distorted by furlough • Retail sales 2.1% rebound from Jan's 8.2% fall • March prelim PMIs rose to 57.9 for manu from 55.1 and 56.8 for services 49.5	• Clocks go forward 1hr to BST • Full national accounts for Q4 GDP, expected unchanged at +1.0%qoq • Current account deficit for Q4 2020 • Lending data (Feb) to include lower mortgage demand ahead of Stamp Duty holiday end • Manufacturing PMI (Mar, final)
Japan	• March Manufacturing PMI Flash is in expansion territory at 52 from 51.4 for the second consecutive month • March CPI Tokyo increased by 0.1pp to -0.2%. New core CPI Tokyo (excl. food and energy) is up by 0.1pp to 0.4%	• Feb unemployment rate should be flat but still biased by strong reliance on subsidy scheme • Feb retail sales should fall with restrictions • Feb IP is unlikely to grow again after strong figure in Jan (+4.2%mom) • Q1 Tankan surveys to gauge companies' confid
China	• Geopolitical tensions escalated with China and the EU engaging in sanctions, risking a delay to the implementation of CAI	• PMI to show recovering conditions in manufacturing activity • FTSE Russell to confirm the inclusion of China bonds in their WGBI index
Emerging Markets	• Rates on hold across the boarding Hungary, Czech Rep, Philippines, S. Korea, Taiwan, Mexico, South Africa • Mid-March CPI in Mexico and Brazil surprised higher. Core inflation fell sharply in SA thus the dovish hold from SARB • First 20-day Korean exports growth on steady recovery +12.5% from 16.8% in Feb	• CB meeting in Chile expected on hold • March CPI in Indonesia, S. Korea, Vietnam, Poland, Peru • Feb IP in S. Korea, Vietnam, Brazil, Chile • March PMI survey across regions • Q4 2020 GDP in Russia, Egypt, Costa Rica

Upcoming events		
	US :	Tue: C-S house price index (Jan), Conference Board cons confi (Mar); Wed: Chicago PMI (Mar), Pending home sales (Feb); Thu: Jobless claims, ISM index (Mar); Fri: Non-farm payrolls (Mar)
	Euro Area:	Tue: EA busi confi (Mar), Ge Sp HICP (Mar); Wed: EA HICP 'flash' est. (Mar), Ge unemployment (Mar), Fr It HICP (prel.,Mar); Thu: EA mfg PMI (final)
	UK:	Mon: Mortgage approvals (Feb); Wed: GDP (final, Q4); Thu: Mfg PMI (final, Mar)
	Japan:	Tue: Unemployment (Feb); Wed: Industrial production (prel., Feb); Thu: Tankan large manufacturers' index (Q1)
	China:	Wed: Mfg & non-mfg PMI (Mar); Thu: Caixin mfg PMI (Mar)

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