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Research & Strategy Insights

Pressure Points

73 – 21 December 2020

Key points

- We take a step back and focus for the last Macrocast of 2020 on the new "big government" zeitgeist.

The next Macrocast will come out on January 11th. We want to thank our readers for their attention and feedback throughout 2020 and wish you the best possible festive season and a great year 2021.

As 2020 is drawing to a close we want to take a step back and discuss the return of "big government" which we think may be a lasting legacy of the ongoing crisis, even if it did not start with the pandemic. Our impression is that traditional, centrist political forces in the western world were in any case already responding to the general populist push by embracing more government intervention. On the centre-left Joe Biden's "most progressive agenda since the 1960s" predates Covid. On the centre-right, the British Conservatives won the last election on a spendthrift manifesto, heavy on state transfers. The pandemic accelerated this transition, for lack of alternative – monetary policy didn't have enough room for manoeuvre to start with and is probably fundamentally ill-equipped to deal with this sort of shocks – and because the sense of urgency precipitated the intellectual conversion to a fairly old version of Keynesianism.

Looking ahead, this "big government" zeitgeist will make it difficult for mainstream politicians to even start talking about the future necessary fiscal consolidation. Popular focus on inequality – which has probably intensified since the beginning of the pandemic – will fuel demand for more redistribution, while a generational conflict for scarce government resources may arise, given the well-documented deterioration in relative income for the millennials and the structural rise in the cost of ageing on public expenditure. It will be tempting to solve the equation with more tax, but this may merely displace the issue – if a large fraction of the middle class is hit by high taxation, this may fuel populism even more. It is also plausible that at least in some countries – in particular the US – redistribution is complemented by action on primary inequality (e.g. wages determination), shifting the pendulum back in favour of organized labour. This could prolong the US discomfort with free trade.

Central banks will be under pressure to act as the politically neutral "adjustment valve" which keeps everything together. At the beginning – and we think for sure in 2021 – this will work just fine. But in the long run we would be creating a "pressure cooker". There is another path, albeit a narrow one: diverting the bulk of this "big government" zeitgeist to projects which would ultimately lift productivity and hence potential growth, instead of transfers. There are elements of that in Biden's platform as well as in the EU's Next Generation Pact. They need to be nurtured.

US fiscal 900bn breakthrough

US Congressional leaders announced on Sunday evening that a "deal" has been found for a continuation of the fiscal stimulus into 2021 with a price tag of USD 900bn (nearly 5% of GDP). Details are still scarce as we write, but in our understanding, both parties compromised: the Republicans have their "direct check" to US families – albeit a smaller one than during the first wave - but let go of their demand to offer businesses a waiver against future Covid-related litigation by their staff. The Democrats won the continuation of the federal emergency unemployment benefit schemes (but also with a smaller top-up, at USD300 per week instead of 600) but gave up on their demand for federal cash to states and municipalities. According to the New York Times on Sunday night the deal also caters for a revival of the Paycheck Protection Program, which subsidizes small businesses in exchange for keeping or re-hiring their employees.

This is consistent with our impression that a political consensus was forming in favour of a "biggish" fiscal push, smaller than the Democrats' 2 trillion initial plans but larger than the Republicans' old red line at USD500bn. The rapid deterioration in the sanitary and economic dataflow has probably focused minds just ahead the expiration of the emergency unemployment benefits offered during the first wave. Retails sales fell in November for the second month in a row, including for the "control group" which takes out the most volatile data. With more states implementing mobility restrictions, this is unlikely to improve any time soon. The US – and global – economy definitely needs an extra layer of stimulus to bridge the next few months before collective immunity is reached.

This USD900bn package may not be the last word on the US fiscal stance for 2021. Out of the 12 polls surveying the Georgia Senate races due on January 5th collected by Nate Silver' 538 website since the presidential elections, 4 of them have the Democrats winning the two seats after correction for past bias, while a 5th one has a tie in one race and a Democratic win in the other. If the Democrats win the two seats, they will command a majority in the Senate. This is very close. The Democrats' difficulty to mobilise their own base and reach out to moderate Republican voters now that Donald Trump has been defeated may be offset by his insistence on "vote rigging" which may have discouraged hardline Republican voters. We note however than the latest three polls released over the last few days all came in favour of the Republican candidates. Our fiscal assumption for our US 2021 forecasts was very similar to the stimulus quantum announced on Sunday night (USD1 trn) but there is a sizeable risk that something closer to double this could ultimately come out.

On the European side the news flow is not encouraging as several countries as of Sunday were preventing passengers and freight from arriving from the UK. The country is dealing with a new variant of the Covid-19 virus which seems to be more infectious (the number of new infections is staggering there, more than 35,000 on Sunday, 2.5 times higher than in France and 1.5 times more than in Germany). Large swathes of the UK have been forced into strict restrictions over Christmas, but we suspect severe mobility restrictions will continue well into January. More Covid hardship on the British side should in principle add to the pressure to agree on a Free Trade Agreement with the EU so as not to add to the short-term shock. The news flow on this front has been quite volatile last week. We continue to think rationality will ultimately prevail, on both sides. Even if the "distribution of pain" is heavily skewed towards the UK, avoiding a no deal Brexit is in everyone's interest.

Beyond this particular saga, our main concern for the next few months in Europe would of course be that the UK variant is already out of control on the continent, which would add to the pressure on the healthcare systems, forcing even stricter lockdowns at a growing economic cost. The budget bills unveiled in the autumn were obsolete a few weeks after release. The deficits will grow further as the second wave is turning out to be longer than expected. As 2020 is drawing to a close and we are looking to 2021 and beyond, it is the fiscal equation which remains our second biggest cause for concern, after the pandemic trajectory itself.

Back to old-school Keynesianism

A striking feature of the pandemic crisis is that, almost everywhere, the same policy response has been chosen without much debate. Keynesianism has won the day, and it is a quite an old version of it.

The neo-keynesian approach which has been shaping the Federal Reserve strategy since the 1990s and adopted by the European Central Bank under Mario Draghi is normally quite suspicious of active fiscal policy. In this model, cyclical fine-tuning is squarely the job of monetary policy, while budgets are there to deal with structural issues (e.g. fostering productivity through research tax credit or redistributing income and wealth). During this pandemic, however, the policy-mix came back to a "pure", 1936 version of John Maynard Keynes' policy recommendations: to cut a long story short, he was suspicious of the capacity of monetary policy to turn the cycle around and placed his faith in fiscal stimulus. In 2020, the role of central banks was reduced to becoming "enablers" of an unprecedented fiscal push, which went much further than merely allowing "automatic stabilisers" to play – explicitly so in the case of the European Central Bank (ECB) as we have already discussed in Macrocast. Three reasons in our view explain this shift back to Keynesian orthodoxy.

The first reason is the fact that monetary policy was to some extent "exhausted" by the time the pandemic struck. The policy rate was already negative in the Euro area and had only started to normalise in the US. True, central banks could try to overcome this with massive quantitative easing programmes – and they did – but bringing long term market interest rates to zero (or also in negative territory in the case of the Euro area's core) would not be enough to bring substantial support to an economy dealing with a sudden, exogenous collapse in activity. To take a simple example, low to negative interest rates can fully offset a sudden stop in firms' turnover only if banks are willing to extend enough credit to cover the entirety of the firms' income free-fall. If banks can't do this without putting their own balance sheet in jeopardy, there is no level of the interest rate and no amount of "liquidity injection" which can suffice. Governments need to step in.

The second reason is that the sense of urgency created by the pandemic ushered a prompt and efficient response by governments, against the predictions of the neo-keynesian model. With the winter recess approaching, your humble servant has been digging into his archives, and the following quote by Nobel Prize winner Robert Solow from a 2002 interview to the Minneapolis Fed review may be a good reminder of why fiscal policy had fallen out of favour in academic circles well beyond the usual free market fundamentalists*: "when you try to do economic stabilization through fiscal policy, you always (probably necessarily) end up with conflicting interests. You can't just say we need higher taxes or lower taxes. You have to have higher taxes in some particular way or lower taxes in some particular way and the people in society and their elected representatives are going to care quite a lot about who is favoured by a tax reduction, who is damaged by a tax increase. The same is true on the expenditure side. Because of this inevitable political process, it's hard to get fiscal policy done promptly".* This contrasts with the capacity of the (nowadays independent) central banks to make quick, technocratic decisions. This time, however, there was not much haggling and the usual political bartering was largely eschewed and politicians of all ideological persuasion understood rapid action was a matter of economic (and political) survival. At least at the beginning.

The third – and maybe more fundamental – reason is that by the time the pandemic struck the "zeitgeist" had already shifted towards more government intervention. The rise in populist movements across developed nations had forced traditional political parties to move away from the government retrenchment platforms which had become consensual since the early 1990s.

Examples abound. Joe Biden's progressive agenda pre-dates the pandemic. Despite his lifelong positioning as a moderate and despite the radicalisation of the Republican party which had left a wide political space in the centre, he chose to appeal to the left of the Democratic party with a large federal spending programme funded by tax hikes focused on the top end of the income distribution. His strategic decision – which proved successful – was to focus on the blue-collar electors of the rust belt, who had a few reasons to consider that since Bill Clinton's centrist shift in the early 1990s the Democratic party no longer was their natural habitat. In France, Emmanuel Macron had to respond to the violent social protests by skewing his government's policy towards more redistribution. Italy – often a "laboratory" where political innovations occur earlier than in most other European countries – provides an interesting experience. There, populist movements (Lega on the right, 5-star on the left) have entered in formal coalitions with traditional centre-right and centre-left parties (Forza Italia and Partito Democratico respectively), which see their survival dependent on taking some distance from the centrist consensus of the 1990s, heavy on structural reforms and fiscal austerity. The UK as usual is running its own course, but even there, the ruling Conservatives have secured their latest election success on a promise to "level up" with the North with not a small amount of government money, and the "buccaneering", free-market Brexit platform has given way to a bitter fight with Brussels on the right to subsidise industries.

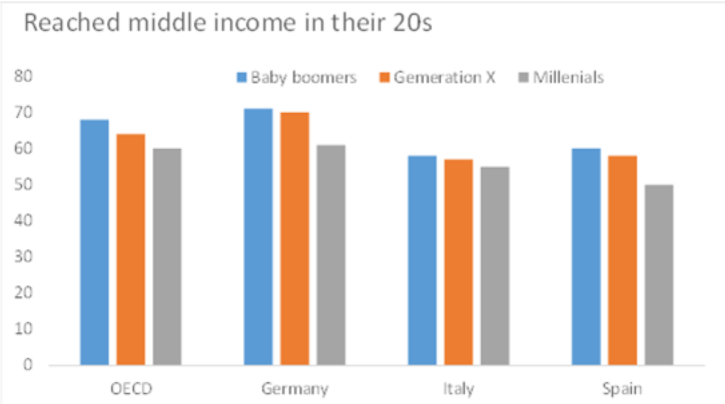
The pandemic has of course accelerated this transformation. It is not obvious that the Social-Democratic finance minister in Germany would have managed to convince the coalition to depart from its usual extreme reluctance to engage in active fiscal policy domestically and accept the principle of debt mutualisation at the European level without the pandemic. However, a lurch to the left of SDP would have probably happened anyway, given its relentless erosion in electoral results since it has been governing in coalition with the centre-right.

Conflicting demands

This configuration will make the transition away from "all out" government intervention difficult post-pandemic. Since the start of the crisis, we have always considered that fiscal policy should remain accommodative for some time after the collective immunity brought about by the vaccines allows some normalisation in supply-side conditions, since we think that demand will remain scarred beyond 2021 after a "relief rebound" in the second half of the year. Still, debt sustainability will need to be preserved and governments will have to provide the market with some visibility on the pace and content of a future fiscal consolidation effort. Even "only that" may be a bitter pill to swallow. Robert Solow's "conflicts of interests" impairing fiscal policy will come back.

Popular focus on inequality – already mounting before the pandemic – has become even more intense. Interestingly, when taking into consideration tax and transfers the OECD data do not point to a "slide down" of middle earners over the last 15 years across most developed economies which would be suggestive of a generic "disappearance of the middle class" phenomenon (the income distance between the top income decile and the median has been stable in most G7 countries). The rise in inequality is more visible however for the bottom decile which has "lost ground" in most countries – France being a notable exception. The most intriguing development though is that generational inequality has been rising significantly. **On average in OECD countries, 68% of "baby boomers" (born between 1942 and 1964) were "middle earners" in their twenties (their income was between 75% and 200% of the median level). This proportion fell to 64% for generation X (1965-1982) and again to 60% for millennials (1983-2002).** The slide has been significant for Euro area "peripherals" such as Italy and Spain where inequality was already quite high, probably under the influence of the peripheral crisis and the accompanying crash fiscal consolidation programmes, but we note that even strong performers such as Germany are dealing with an acute rise in generational inequality (see Exhibit 1).

Exhibit 1 – Generational inequality on the rise

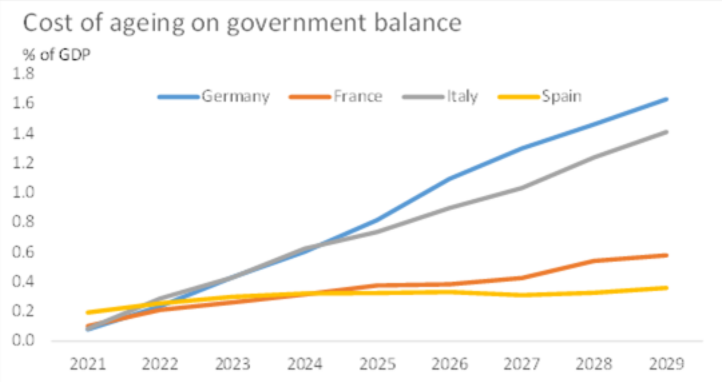


Source: OECD, AXA IM Research, December 2020

Beyond these general trends, social and age groups have not been equal when dealing with Covid-19. Most white-collar workers have been able to work from home and with some sectoral exceptions have been quite well protected against the sanitary and economic consequences of the crisis. Blue-collar workers and "front-line" public sector employees have taken more risks. Young people who are seeing their integration on the labour market delayed by the pandemic crisis and "peripheral workers" only loosely attached to their employers (seasonal, fixed-term contracts) have been on the fore-front of the employment contraction (there is quite a lot of overlap between the two categories by the way). This is likely to fuel popular support for more redistribution and generous provision of public services in the years ahead.

Still, at the same time public finances will still need to deal with the "old" structural forces pushing government's expenditure up. In Europe in particular ageing is going to lift structural spending via the rise in the weight of public pensions and the drift in healthcare payments. The cost of ageing as estimated by the European Commission will vary across countries according to the depth of previous reforms on healthcare and pensions, together with the underlying demographic situation, but in countries such as Germany and Italy, without changing regulations, ageing would incrementally deteriorate the government fiscal balance by roughly 1.5% of GDP every year by the end of the decade (see Exhibit 2). Germany can very likely deal with this. For Italy it's another headache.

Exhibit 2 – The ageing bill can be expensive



Source: European Commission, AXA IM Research, December 2020

Governments will gradually be faced with a thorny generational conflict for their scarce resources. Temptation is going to be strong to deal with this by raising tax, especially since the high-income individuals have benefited from the impact of extremely accommodative monetary policy on asset prices. The issue there, as often, is that the return on taxing the wealthiest is often disappointing given their high international mobility. Odds are that the rise in tax – first focused on the top decile – would gradually percolate towards more median earners. This displaces the issue; it does not solve it. From a political point of view, the risk in hiking tax for large swathes of middle earners is to precipitate this social group towards populist solutions. Drawing again from the Italian experience, Lega originally emerged as an anti-tax movement in the North complaining about what they saw as "government waste" in the South.

Primary inequalities and (de)globalisation

Dealing with inequality need not focus on redistribution. **Primary inequalities can also be tackled, and it is possibly there that Joe Biden may trigger the biggest structural change in the US** (together with his support for the green transition). In his first long speech after winning the election, he presented himself as "*a union man".* He is to our knowledge the first US President to say this since probably Lyndon Johnson in the 1960s. He seems intent to "shift the pendulum" towards organized labour. From this point of view, we were intrigued by a New York Times article published on December 15th describing how the Biden administration could push for workers' rights even in the absence of a majority in the Senate, using existing frameworks. For instance, they could cede to the states the possibility to regulate labour relations in certain industries. This could allow for instance the deeply Democratic state of California to intervene in favour of "gig workers". The choice of the personnel in charge of running the federal labour agencies, pushing for stricter enforcement of regulations, would also be key.

However, the most interesting point in this article was the **conflation of labour relations issue with trade policy**. The New York Times piece, which it would be an understatement to qualify as close to the Democrats, mentioned the new options offered by Donald Trump's revision of the North American Free Trade Agreement (NAFTA). Indeed, the new treaty allows the US to block imports from facilities in Mexico which curtail workers' rights. The piece continues by stating that "*pursued aggressively, the enforcement could help mitigate downward pressure on US manufacturing wages stemming from unfair competition with Mexico".*

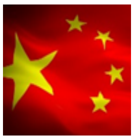
In our view, this is a much more credible threat to globalization than the often discussed "shortening of supply chains" which the pandemic would have brought about. It might be that traditional political forces consider that they can resist populist pressures at home only at the cost of jettisoning for good some key aspects of the old "Washington consensus" such as unfettered free trade. This would have probably happened anyway, but the Covid crisis is accelerating the phenomenon.

Central banks saved by productivity?

None of this is probably good news for central banks, whose independence blossomed as the "Washington consensus" was spreading worldwide. Market deregulation, free trade, fiscal prudence and the primacy of independent monetary policy as the main source of cyclical fine-tuning went hand in hand. There is no immediate threat since for now – and we suspect for several years – there is no conflict of objective for the major central banks in the developed world. In a context of low inflation (and actually deflation risks), nothing stops the central banks from consciously – as they are doing now – or inadvertently – as we suspect they will for several years – keep governments' financing conditions consistent with debt sustainability.

But what if we push our reasoning to the extreme? While both cyclical conditions and economic agents' expectations are *currently* inconsistent with a return of inflation, in the long run, the combination of sustained government intervention, re-regulation of the labour market and the prolongation of protectionist tendencies would provide the right conditions for inflationary pressures. A conflict of objectives would arise. In our view, market discipline would ultimately force monetary policy to tighten, even if central banks remained reluctant to do so given the shaky state of public finances.

Still, what we described in this piece is a "plausible path", but by no means the only possible one. Traditional, centrist political forces did not in one day convert to a "return to 1970". The re-regulation template is tempered by clear efforts to divert as much of the fiscal programmes to productivity-yielding investment instead of mere transfers. A virtuous circle can be the result of the current configuration, where infrastructure spending helps re-start potential growth, especially if it is accompanied by tough competition policies to encourage the diffusion of new technologies. There are elements of this in Joe Biden's platform, as well as in the EU's Next Generation Pact. It will be a narrow path for politicians of course, but we want to end our last Macrocast of the year with a positive note.

Country/Region	What we focused on last week	What we will focus on this week
	• FOMC left policy unchanged, no maturity extension, added guidance on QE outlook • Virus worsens, rising new cases and positivity • Electoral college meeting confirms Biden as President-elect, Republicans begin to accept • Stimulus talks focus on a $0.9trn package • US retail sales fell by 1.1% in Nov, Empire State and Philly survey retrace in Dec.	• US stimulus and spending bill would provide extension of jobless schemes past 31 Dec. • Virus developments, though real concern is any post-Christmas pick-up in early January • November personal spending and income releases, income fell by 0.7% in Oct. • Q3 GDP – final revision • Conf Bd consumer confidence for Dec.
	• Germany announced more stringent lockdown during Christmas break • Flash PMIs were better than expected. Mfg and services were up respectively to 55.5 and 47.3 from 53.8 and 41.7 • German IFO surprised to the upside with continued strength in business climate, current conditions and expectations	• Brexit negotiation • January GfK consumer sentiment is likely to weaken following stricter restrictions • Dec. consumer confid. should be impacted by stricter restrictions in some countries
	• Continued Brexit negotiations, some progress on level playing, fish still an issue • BoE left policy unchanged, outlook focused on uncertainty, with hopes for vaccine • UK extended Tier 3 to 38m (+15m), UK estimated op capacity at 96% from 97.5% • Retail sales and inflation fell, jobless up	• UK-EU trade deal saga: we still expect deal, but time runs out on 31 Dec. • Virus outlook, trend is rising again • Final Q3 GDP est and full national accounts • Q3 Current Account balance • UK public finances for November
	• Q4 BoJ Tankan surveys improved but biased by December stricter restrictions • November exports weakened (-4.2%yoy) • Dec Mfg PMI flash is up by 0.7pt to 49.7 but remains in contraction territory • Nov CPI declined to -0.9%yoy/-0.3% for core	• December CPI Tokyo is likely to remain very weak (consensus: -0.8%) after -0.7% in Nov. • Nov. unemployment rate and job/applicants ratio should remain unchanged • Nov. retail sales and preliminary IP are likely to progress before weaker figures in Dec.
	• November activity data saw a broad-based improvement. Both IP and FAI growth strengthen further. Retail sales growth also continued to improve, helped by solid Single's Day online sales	• December's headline manufacturing PMI to remain expansionary
	• Banxico kept policy rate unchanged mentioning that the future evolution of prices would trigger necessary action • BSP and BI kept policy rates on hold on optimistic near-term outlook	• Central bank meetings: Turkey (hike expected) • Korea's first 20-day export growth to weaken slightly compared to November on the back of the recent virus relapse • Mexico mid-month CPI; core CPI should increase after "Buen Fin" sales period and slight improvement in tourism-related services
Upcoming events	US :	Tue: GDP (final, Q3), Conference Board con conf (Dec); Wed: Core PCE index (Nov); Thu: Durable goods orders (prel., Nov); Tue 29: Case-Shiller index (Oct); Wed 30: Goods TB (adv., Nov)
	Euro Area:	Mon: EA Cons conf (adv., Dec); Wed: It ISTAT business & consumer confidence (Dec), Sp GDP (final, Q3); Wed 30: HICP (prel., Dec); Thu 31: End of Brexit transition period
	UK:	Tue: GDP (final, Q3), PSNB ex-banking groups (Nov), Current account (Q3), Business investment (final, Q3), Private consumption (final, Q3); Thu 31: End of Brexit transition period
	Japan:	Wed: Leading index (final, Oct); Thu: Unemployment (Nov); Fri: Housing starts (Nov)
	China:	Sun: Industrial profits (Nov); Thu 31: Official manufacturing & non-manufacturing PMI (Dec)

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