BANQUE
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FIVE ECONOMIC POLICIES WHICH DO NOT REACH THEIR TARGETS

Chesterton on Francis of Assisi: "He could not see the forest for the trees",
quoted by François Mauriac in his Journal.

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It is tricky to criticise economic policies because our perception is approximate, but when applied to the economy, Chesterton's words above help us to distinguish between the short term, the immediate effect of a policy, and its knock-on effects. Additionally, it can illustrate the short-sightedness with which certain policies are implemented and the effects they may have on financial markets. This is the purpose of this note, which will analyse five policies:

- Brexit, or a no-deal exit from the European Union, a factor weakening the British economy.
- Interest-rate cuts, an instrument that is now ineffective in stimulating the economy.
- The agreement between OPEC and Russia to cut production, an inefficient policy to raise crude prices above $70/barrel.
- The substantial corporate tax cuts in China, or the reduction in the rate of reserve requirements, measures which are ineffective in their attempts to check the structural slowdown in Chinese growth.
- The tariff measures decided by Trump, which are counter-productive for the US economy.

I. **The limitations of a hypothetical Brexit**:

- ***In face of the unknown, choose caution***: Three years after the referendum, it must be said that everyone is somewhat bewildered, incapable of making a prediction and wise not to touch the pound sterling. And this reminds us of the saying by ***Kipling*** in his poem "The English Flag": "***And what should they know of England who only England know?"*** Given the Conservatives' failure in the European elections, winning less than 10% of the votes, their divisions between Brexiteers and Remainers, the "victory" of the Remainers with 40% of the votes compared with less than 35% for the supporters of Nigel Farage, the wise thing would be to have another referendum. But nothing is less probable. Since the mid-1960s, Jeremy Corbyn has been an opponent of Europe and the press is mostly in the hands of Brexit supporters. With regards to Boris Johnson, appointed prime minister by only 100,000 votes of Conservative Party members and having only a two-seat majority in the House of Commons, his intemperate nature - part bluster, part mischief - compels him to assert that he will carry off this difficult undertaking in a mere few weeks, when in three years Theresa May was unable to put a dent in the European consensus and just when at the first false move he could be overturned by a no-confidence motion. In choosing him the British were perhaps thinking of this saying by ***Pierre Dac:*** "***When you see where so many good minds have led us to, it is legitimate to ask oneself whether it is not urgent to try a poor one.***" So, the risk of exhausting the patience of Brussels and hence the risk of a no-deal Brexit is becoming more likely even though parliament demands to have its say. Some, remembering the referendum of 1975, when 66% were in favour of Europe two years after joining the Union, imagine another referendum in a few years' time, when the damage will be clear to everyone. But it will be too late.

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- ***The harmful effects, already obvious, will get worse***: Before the vote, the United Kingdom enjoyed the strongest growth among the major EU countries, while in 2018 it posted one of the weakest rates, at 1.4%. The pound has weakened by 20% since the vote, but the trade deficit has not been reduced and the current-account deficit, an indicator of dependence on foreign capital, still stands at 5% of GDP. Foreign investments have quite logically dried up, business leaders, e.g. at Honda which is going to close a unit employing 3,500 workers, are increasingly sending out warnings, and certain sectors such as the automotive industry are suffering severely from this wait-and-see attitude: production has declined by more than 15% year on year. The historic model of English democracy is being hurt, and its two major parties are no longer representative. The idea of moving closer to the United States in the wake of Brexit is an illusion, because England has never interested the United States except as a Trojan horse to prevent Europe from establishing joint policies. The idea that a free-trade agreement with China would cause a surge in trade between the two countries is a mirage, because less than 4% of British exports go to China, and it would also annoy Trump! So our recommendation for investors is not to take positions on the pound or the UK market for now.

II. **The limitations of monetary policies**: Three points should be noted

The challenge facing central banks is simple: it is no longer inflation, which is make-believe, but managing the reality of global debt, standing at $245,000 billion in 2018, or more than three times global GDP ($85,000 billion), and increasing faster than wealth creation.

- ***The short-sightedness of central banks***: Fundamentally, doubt could set in. Perceived as growth look-out posts, like oracles, central bankers enjoy exceptional credit in financial markets. But the Fed's turnaround is very perplexing. Remember that, in October, the mantra was three interest-rate hikes in 2019. Now the Fed puts forward the idea of a rate cut at the end of July and probably one or two others by the end of the year. Has the economic situation changed so radically in a few months? Has the Fed shown short-sightedness or, quite simply, is it not yielding to the “dictatorship of the markets”? You can talk about the risks of a recession, dwell on the slowdown in manufacturing or deplore the wait-and-see attitude of companies which prefer to put off outward investment rather than be exposed to ill-advised customs duties, but the reality of the employment figures, real wage growth and the vitality of activity in the service sector should suffice to dispel fears and postpone interest-rate cuts. Two final comments on this point. It is essential that operators should not come to think that politics influences central banks' decision making, which it definitely does in Turkey and India, and is suspected of doing in the United States. Trust would be destroyed and stock market prices would be affected. Nor must central banks take the place of governments in conducting economic policy; remember what ***Milton Friedman*** said in his book “Inflation and Monetary Systems”: “***The fact of delegating extensive economic powers to central bank governors seems to me absolutely contrary to liberal principles.”*** Hence the calls by some for a more ambitious fiscal policy to take over, which is a highly commendable idea if this means investment in infrastructure, education and research, but debatable if it means new current expenditures.

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- ***The complacency of central banks***: The ambition of monetary policy should not be to pave the way for the re-election of a president but to facilitate GDP growth while containing inflation risk. By what is the sense of a monetary policy governed by an inflation target that is never reached? For example, core inflation of 1% in the eurozone compared with a target of 2%. Would it not be better to define new targets, such as growth in employment or investment? With no risk of inflation, central bankers have great capacity for purveyance and leeway for intervention, but by trying to strengthen economic growth which is not threatened by a recession, they run the risk of lacking the means to offer stimulus in the next recession. Quantitative easing policies have a moderate impact on growth. It could be argued that without the huge liquidity injection by the Fed and then the ECB, the post-2008 recession would have been deeper, inflation would possibly have been negative, the euro might not have survived, and more recently the spread between German and Italian bonds would not have been reduced from 300 basis points to 200. But the limitations are obvious. Credit growth remains weak and relatively uncompetitive businesses manage to survive, distorting competition and resulting in deflationary pressures. Furthermore, real estate is suffering from bubbles, the situation of the banks is undermined by negative interest rates which cost eurozone banks €8 billion, and their stock market valuation has never been as low. The only positive factor, although perversely, is the reduction in interest charges on the public debt. To take just one example among all the others, in the United States the average interest rate on debt was 2.5% in 2018 versus 6.5% in the early 2000s.

- ***Relative ineffectiveness of an interest-rate cut by central banks***: Since the start of the year, more than 30 central banks, including 27 in emerging countries such as India, Malaysia and the Philippines, have lowered their interest rates. Last week, South Africa, Indonesia and South Korea did the same. Admittedly it is positive to note in many major OECD countries a differential of 1 to 2 percentage points between the level of interest rates and the GDP growth rate. At present, it is $13,000 billion, or around one-quarter of the sovereign debt of OECD members that benefit from negative interest rates, especially after inflation. This completely unprecedented phenomenon wipes out part of the debt, but economic growth is lower than in previous cycles because this liquidity fuels savings deposits rather than spending and investment. In light of the disappointing credit growth of recent years, it is doubtful that US interest-rate cuts from 2.5% now to possibly 1.75% or even 1.50% one year from now will positively impact the economy. Despite a situation of close to full employment and real wage growth, an edifying example is provided by the stagnation of housing starts last year and the recent fall in sales and prices on the West Coast, even though US 30-year mortgage rates have fallen from 4.75% a year ago to 3.75% now.

The winners in a forthcoming fall in US interest rates, and hence liquidity injection, include emerging countries which will benefit from an inflow of dollars: their currencies can be expected to rise, imported inflation should fall, foreign-currency debt, i.e. more than 40% of Turkish debt, and more than one-third of Russian, Mexican and Indonesian debt, should be reduced and it would be easier to lower interest rates in local currency, whether in Turkey which has 24% interest rates for 16% inflation, or again South Africa, Russia, etc.

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III. **The limitations of OPEC's policy**:

OPEC accounts for only one-third of global production and is struggling to conceal its divisions (just consider Saudi Arabia's hostility to Iran). With Russia and 24 other producers, an agreement to cut back production by 1.2m bpd was extended until March 2020. However, despite fears of blocking of the Strait of Hormuz through which pass 17 million bpd, despite a fall in Iranian exports from 2.5m bpd to 0.4m bpd in the space of one year, partly explained by Europe’s inability or unwillingness to promote a barter system, despite Venezuelan production having fallen to a very low level, despite turmoil in Libya, despite the lagged effects of the contraction in exploration budgets from $800 billion in 2014 to $430 billion in 2016, and despite the prospect of falling interest rates which will stimulate growth, the price of Brent is struggling to reach $70/barrel. In other words, the price trend is generally downward and the share price performance of oil producers, with +9% this year for the S&P 500 Energy compared with +19% for crude prices, reflects this impression. The Chinese have refused to give in to threats from Trump, and therefore continue to buy Iranian crude oil using smaller companies, less exposed to US sanctions, which will therefore not stop Iranian exports. The only brake on this price decline would be a shortfall in the supply of US shale oil. Possibly premonitory signs measured by the Baker Hughes index are a reduction in the rig count, from a peak of around 880 to 785 last week, and a smaller expected increase in shale oil production, by 1.2m bpd in 2019 following 1.6m bpd in 2018.

IV. **The limitations of the stimulus policy in China**: ***"Firstly think whether it is fair and possible to do so, for your promise is a debt", Confucius.***

This saying by Confucius could be wise advice for a Chinese government that is banking heavily on growth to allow sufficient job creations to curb social protest, to ensure the country's technological catch-up with the United States by means of the China 2025 Plan and, via the Belt and Road Initiative, to project China's presence beyond its borders. All these ambitions are costly in terms of debt and the return on capital employed.

- ***An inevitable slowdown***: We have long been worried by the Chinese government's contrivances to try to offset a structural growth slowdown, but successive quarterly figures merely confirm this trend. The latest known plan, in March 2019, consisting of €260 billion in tax cuts, had no major impact! Contrary to the impression of many observers, the tariffs imposed by Donald Trump only marginally account for this growth slowdown. Over-investment in infrastructure and real estate, over-investment in numerous sectors of industry, over-investment financed by debt and overcapacity in state-owned enterprises that are not very profitable: this was the model followed by the Chinese in recent years, and this is the source of the current problems. The model is commonly used for each stimulus plan, which is less and less effective and increasingly looking to be unsustainable.

- ***Factors of anxiety***: The anxiety surrounds China's capacity to raise Chinese per capita income to the level of Western countries. It also concerns spiralling debt, from 1.5x GDP in 2008 to 3.1x at present, some $40,000 billion (!), which implicitly means ever more debt is needed to increase GDP by 1 yuan. On the back of a private savings ratio equivalent to 48% of GDP, the Chinese authorities can continue along these lines for a few more years, but the

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process will come to a dead-end, even though in the short term some will be pleased by a 6.3% rebound in industrial production and 9.8% growth in retail sales in June.

V. **The limitations of Donald Trump's trade policy**:

- ***Trump, an adept of René Girard's scapegoat theory:*** Although probably not a reader of Girard, Trump seems to be applying his principles in the runup to the 2020 election and is thus looking for scapegoats: one day China, another day Iran, sometimes the euro, all to galvanise his supporters. It should be remembered that apart from the hotchpotch of tweets, his results have been meagre. There was the far from unanimously supported pull-out from the Paris climate agreement. There has been a tax reform offering lacklustre effects, because cash repatriation by companies represented a total of only $680 billion in 2018 out of an amount of almost $4,000 billion. Then there is investment which, at 13.8% of GDP in the first quarter of 2019, has hardly increased whereas share buybacks represented a record amount of $805 billion in 2018 and still $205 billion in the first quarter. Lastly, federal revenues declined to 17% of GDP in Q1, so that the budget deficit widened to a record peak-of-cycle level of 5% of GDP.

-***The inability to weaken China***: Three comments. First, Trump arrived 10 years too late. In 2008, China's current-account surplus represented 10% of GDP, and exports were an essential component of Chinese growth. At the end of 2018, the economy was substantially more dependent on the domestic market, the foreign exchange reserves of $3,200 billion were no longer increasing and had fallen by around $1,000 billion from their peak, while the surplus was now only 0.4% of GDP, no more than $60 billion. Net exports now account for only a small percentage of GDP, direct investment by Chinese firms on American soil fell to $5 billion in 2018, an amount far from the $45 billion posted in 2016, and some multinational companies are moving offshore from China to Vietnam for manufactured goods or Bangladesh for textiles, though it is not easy to escape from a local microcosm which has numerous subcontractors.

Second, to have any chance of succeeding in twisting China's arm, Trump ought to have continued along the path trodden by Obama, i.e. firstly the Trans-Pacific Partnership Agreement (TPP), a free-trade agreement between the major Asian countries, and secondly coordination between all these countries to put pressure on China. But Trump chose the reverse option, pulled out of the TPP agreement and let historical partners of the United States negotiate a free-trade project involving China, India, Japan, Australia, South Korea, etc., i.e. half the population of the planet! The measures imposed by Trump affect only 10% of Chinese exports, i.e. scarcely 2% of Chinese GDP. There is nothing to suggest a contraction in the bilateral deficit with China, which was $375 billion in 2018. But taxes harm the US consumer to the tune of $20 billion per year, which makes one think of ***Camus' words in Caligula, Act I, scene 8: "It is not more immoral to steal from citizens directly than to slip indirect taxes into the price of food staples which they cannot do without. Governing is thieving, everyone knows that."***

Finally, whenever Trump believes he is weakening a key Chinese technology player, such as Huawei with the temporary ban on supplies of US components, he merely strengthens the determination of the Chinese authorities to accelerate the "China 2025" plan for promotion of a range of key technologies, and to increase the research budget, which is already 2.1%. This same desire for emancipation can be seen in the creation of the "Chinese Nasdaq",

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although, for the time being, it is limited to 25 tier-two stocks, since the big Chinese tech companies remain in New York or Hong Kong.

- ***The inability to weaken the dollar***: In 1985, in the Plaza Agreement, the United States managed to weaken the dollar because it was supported by the cooperation of the main central bankers. It should be remembered that, between 1980 and 1985, against the Deutschmark alone, the appreciation had been nearly 90%. Today the ECB watches, even though exchange rate policy is the responsibility of the European Council. Mario Draghi's statements and decisions will counter any action by the US Treasury Department or the Fed aimed at weakening the dollar.

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Conclusion: ***"The friends of truth are those who search for it and not those who boast of having found it", Condorcet*** in his speech on National Conventions in April 1791.

It is not easy for economic policies to reach their target, but we will conclude on a note of confidence in short-term growth, but without overlooking the incompetence of these policies on more distant horizons, which justifies a note of caution regarding markets:

- ***The global economy is not yet on the eve of a recession*** but central banks are already striving to prevent this possibility. Some are alarmed by the slowdown in global trade (2.5% this year versus 8% annually in the early 2000s), they worry about a first-quarter contraction of investment in India, Indonesia, the Philippines and Thailand, and are anguished at the sharp recent contraction of Korean and Indonesian exports. But this is to underestimate the skewing of economies from manufacturing to domestic services, to exaggerate the protectionist threat, to forget that the first-quarter growth figures were better than expected everywhere in the OECD, and to overlook the recent rise in the sentiment of economic agents both in Europe and in the United States and the robustness of consumption and services. Not surprisingly, the IMF expects 3.2% global growth, with 2.6% in the United States, 1.3% in the eurozone and 0.9% in Japan.
- ***In the longest growth cycle in the post-war period, lasting 10 years, a few states, such as Switzerland, Germany and the Netherlands, have achieved a budget surplus*** and started to reduce their public debt, and no central bank has been able to mop up the liquidity injected. The Fed, which is the only central bank to have taken this path, has only reduced its balance sheet from $4,500 billion to $4,000 billion, a very long way from the $800 billion of 2007, as it watches public debt spiral to 107% of GDP, i.e. $22,800 billion. At the other extreme, the Bank of Japan, without blinking and without doubting, has confirmed its policy of purchasing government bonds at a rate of 13% of GDP each year, and equities amounting to 1% of Japan's market capitalisation. Its balance sheet represents the equivalent of 1x GDP, the 10-year bond yield is kept at zero, and apparently nothing can stop this lax policy.
- ***Let us speculate on a continuation of accommodating policies,*** because ultimately the unconfessed objective is to maintain fiscal solvency.
- ***In the view of market investors, the risks are contained***: forgotten, the risk of rising interest rates; moderate, the risk of protectionism; ruled out, the risk of a recession in the United States; spread out over time, the risk of a Chinese slowdown; unlikely, the oil price risk; diminished, the risk of capital outflows from emerging countries. Financial markets, even sobered by stagnant corporate earnings, will appreciate. Therefore, after the exceptional rise in portfolios since the start of the year, partial hedging of equity exposure is justified, and diversification into the Swiss franc, gold or US Treasuries. Bear in mind what ***Corneille says in Andromède, Act II scene 4: "I confess to you that it is very harsh to lose everything just when you should be considering yourself fortunate"***.

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