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MACRO UPDATE: TEMPORARY TRADE TRUCE; A 5STAR RECESSION IN ITALY? TROUBLE FOR MACRON

Berenberg Macro Flash

G20: A TEMPORARY TRADE TRUCE

Escalating trade wars would pose the biggest risk to our call that the world economy is heading for roughly trend growth in 2019. With the US-Chinese deal at the sidelines of the G20 summit, the risk has not been defused. But it has receded slightly. The US will delay the rise in punitive tariffs from 10% to 25% on 200bn US dollars worth of imports from China for 90 days while China has pledged to buy more from the US. The US has given China extra breathing space for talks to settle their trade differences.

Two other aspects of the G20 results are also mildly encouraging:

1. In the official communique, G20 leaders pledged to “support the reform of the WTO to improve its functioning”. So far, US president Donald Trump had seemed more inclined to cripple than to strengthen the WTO. A reform of the WTO could serve to rein in US protectionist tendencies and China’s sometimes predatory behaviour at the same time.
2. According to European Commission president Jean Claude Juncker, “the President of the US and I have come to a common understanding of how to develop our trade relationship...and we are working hard to fulfil our joint ambition of slashing costs and further easing trade”.

The threat of a 25% US tariff on car imports from the EU and elsewhere is probably not off the table yet. Trump is known for making conciliatory statements at international gatherings first before returning to his earlier harsh rhetoric once the summits are over. For him, threatening to impose car tariffs in some months’ time unless the EU were to make unilateral concessions first would be in line with his usual confrontational approach to trade issues. Nonetheless, the Buenos Aires results broadly support our assumption that trade war risks will not materialise badly over the course of 2019. If so, that would allow the global economy to dodge a major bullet and help growth in the heavily trade-dependent Eurozone to rebound somewhat from spring 2019 onwards after a grey autumn and winter.

ITALY: A FIVE-STAR RECESSION?

Italy is starting to pay the price for the follies of its radical government. Revised Q3 data show a 0.1% qoq decline in real GDP instead of the initial flat estimate. As a result, we have shaved our call for 2019 Italian growth from 0.7% to 0.6%. Risks are tilted to the downside. The fall in Italy’s composite PMI output index to a 59-month low of 49.3 in October and the weakness in other concurrent indicators (economic sentiment down to 105.9 in November after a 108.6 average for Q3) highlight the downside risk to our call that the Italian economy will expand again slightly from Q4 onwards.

Of course, quarterly data are too volatile to read much into them. For example, the scary 1.1% qoq decline in fixed investment which dragged Italy’s GDP down in Q3 has come after an implausibly strong 2.8% qoq surge in investment in Q2. Still, the weakening in the data is both broad-based and more pronounced in Italy than elsewhere in the Eurozone. In Italy, we cannot attribute the disappointing Q3 result mainly to special one-off factors, as in the case of the German output plunge in the wake of new emission testing standards for cars. In Italy, the spending plans of the radical government, the resulting rise in risk premia and the concerns about parts of the banking system are taking their toll. Instead of providing at least some debt-financed temporary boost to Italy's GDP, the alliance of 5Stars and the Lega seems to be hurting Italy already.

So far, a remarkable upturn in the Italian labour market had been the signature achievement of the Renzi reforms in earlier years. Unfortunately, progress seems to have stalled shortly after the radical government took power in June. Against the still positive trend elsewhere in the Eurozone, Italian unemployment has edged up by 160k from August to October versus a continuing drop by a total of 150k in the remainder of the Eurozone. Sadly, Italy's youth unemployment rate has risen from 31.5% to 32.5% since July. The data show that Italy can neither afford the expensive spending promises of the 5Stars, which the Lega continues to back, nor the conflict with Brussels and markets about its fiscal plans. As discussed before, we expect Italy's government to back down somewhat under the pressure of markets eventually. However, some serious damage has already been done. Amid a softening economy, Italy would have to abandon most of its extra spending plans for 2019 if it wanted to keep its fiscal deficit close to 2% of GDP instead of risking a breach of the symbolic 3% ceiling. The new Italian data will add spice to the discussion about Italy at today's Eurogroup meeting in Brussels.

FRANCE: YELLOW VEST PROTESTS

Facing yellow vests, Macron does not see red. The "yellow vest" protest movement has turned into the biggest challenge for French president Emmanuel Macron yet. While the protests are drawing fewer people onto the streets (282k on 17 November,106k on 24 November and 75k on 1 December), the protests have become more violent.

Following a significant surge in oil prices, the protests initially focussed on Macron's determination to raise petrol taxes again in 2019 after an earlier increase at the start of 2018. That the higher petrol taxes are meant to make the tax system more eco-friendly and that the receipts are largely used to cut other taxes has not soothed the anger of those often rural voters who rely on their cars for long commutes. Over time, the protests have broadened out to an overall rejection of Macron's policies and his presidency.

In a move to calm the situation, the French prime minister will meet the opposition and some "yellow vest" representatives this week, possibly as early as today. While the government may offer some concessions, perhaps a delay in the tax hike if oil prices were to surge again, we do not expect Macron to back down significantly. The 30% drop in oil prices from their peak in early October should lead to a significant decline in pump prices shortly. In turn, this could help to contain the protests.

In our view, Macron's labour market, tax and other reforms have already improved the long-term growth potential of the French economy. However, reforms often hurt before the positive results become visible. Macron's approval ratings have plummeted this year. Macron's party may not do well at the European election next May. Still, it is early days for the French president. He can cope with some setbacks as he is not facing re-election before 2022. He enjoys a comfortable majority in parliament while the opposition remains in disarray. Despite the current spate of protests, Macron will probably be able to implement some further reforms in the next 12 months. Although he may not be able to deliver on all his reform promises, we maintain our big call that his reforms will reach the critical mass needed to turn France into a significantly more dynamic economy over time. France could still be heading for a golden decade.

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