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MACRO UPDATE: US AND GERMAN POLITICS, UK FISCAL, CORONA

Berenberg Macro Flash

US politics: advantage Trump – or not really?
US President Donald Trump had a great start into the US election season. After the early end of the impeachment trial in the Senate and the Iowa caucus chaos for the Democrats, betting markets suggest that Trump has a 58% probability of winning re-election on 3 November (www.electionbettingodds.com). However, not all trends are in his favour. While it is still far too early to come up with any genuine assessment, two aspects of the Iowa and New Hampshire results are noteworthy.

First, the left-wingers (Bernie Sanders and Elizabeth Warren) are not doing particularly well. Whereas Bernie Sanders won in New Hampshire, as expected, he did so only by a narrow margin with c26% versus 24% for Pete Buttigieg, 20% for Amy Klobuchar and a mere 9% for Warren.

Second, among the moderate Democrats, the youthful Buttigieg and Klobuchar have momentum on their side versus former vice president Joe Biden who has run a lacklustre campaign so far. Judging by the 2016 election, when Trump narrowly won against old political stalwart Hillary Clinton, these newcomers may well have a reasonable chance of prevailing against Trump in a rough contest. They seem to be energising some centrist voters who do not like Trump but are reluctant to support a left-wing Democrat. The other key moderate, Michael Bloomberg, has not entered the field yet, focussing his energy and money on the Super Tuesday primaries on 3 March. On balance, the outlook for a moderate Democrat to clinch the nomination and take on Trump seems to have improved a little, at least as judged from afar.

German politics: good or bad news in the end?
After Merkel's heir apparent, Annegret Kramp-Karrenbauer (AKK), announced on Monday that she would not lead the CDU into new elections, the pressure on her party to choose a candidate for the chancellorship soon is growing. The pro-business Friedrich Merz and the widely respected prime minister of big NRW, Armin Laschet, remain the top two contenders to succeed Merkel, followed by health minister Jens Spahn. However, the key question is not who will strive to follow Merkel. Instead, we have to ask whether the risk that the conservative CDU/CSU may not end up in government at all after new elections is rising or not. From an economic point of view, only a shift from a coalition in which the CDU/CSU leads the government to one where the Greens team up with the centre-left SPD and the left-wing Left Party instead would make a significant difference. With an inclination for heavy regulation along the lines of the housing rent cap in the city state of Berlin, where a red-red-green coalition holds sway, such a federal government without the CDU/CSU could undermine the longer-term growth potential of Germany.

Near-term, the Thuringia scandal where the right-wing AfD outwitted the CDU/CSU and the liberal FDP could dent support for the CDU at the federal level, as it has already done in Thuringia. It would thus raise the risk that a green-red-red coalition could win a majority at the next federal election. In pre-Thuringia opinion polls, these three parties were jointly c2%ppt short of such a majority. However, the near-term impact of the current political upheaval need not matter much. As the SPD seems determined to stay in Merkel's coalition for the time being, the risk of snap elections this year remains modest. Longer-term, that is in time for the regular election date in September 2021, the CDU may well recover. Haunted by a few early missteps, AKK had failed to raise support for the CDU. Both Merz and Laschet may well do better on that count. If so, the change at the top of the CDU could – in the end – even reduce the tail risk that Germany ends up with a green-red-red government in 2021.

UK: towards a pro-growth mix of tax and spend?

The recent newsflow suggests that prime minister Boris Johnson and chancellor Sajid Javid could announce a so-called mansion tax (an annual levy on high value homes) and cuts to pension relief at the 11 March budget. A mansion tax could be a simple levy on homes above a certain value or it could be imposed through changes to the current council tax. Pension relief could be, for instance, capped at 20% instead of the contributor's marginal income tax rate (+40% for high earners). The precise details are unknown and the current newsflow may not be much more than trial balloons or rumours. While the scale and yield of any such taxes will ultimately determine the economic impact, we would view a modest rise in such taxes as a sensible.

First, modest tax hikes would partly help to finance the ongoing fastest rise in day-to-day government spending - announced last September – in fifteen years and a promised £100bn of extra public sector investment over five years (more details to come in the budget). Following nearly a decade of gradually reducing the public sector deficit towards a safe level, from a peak of c10% in 2009 to c2% last year, we had argued that a deficit-financed spending spree would risk raising the deficit to a level that would make the public sector finances vulnerable during the next downturn. Modest tax hikes to finance at least part of the planned spending can help to mitigate this risk.

Second, as long as such tax hikes are modest, we would not worry too much about the negative consequences for growth. We may only need to adjust down our current call that fiscal policy can add c0.7ppt to headline growth by 0.1ppt. As a mansion tax and a cut to pension relief would disproportionately affect higher earners whose marginal propensity to consume is fairly low, the so-called fiscal multiplier would be low too. Such hikes would not offset the growth-benefits from the planned spending rise. For infrastructure spending we assume a total multiplier of 1.2-1.3 over a three year basis. But for tax hikes – especially on high earners – that multiplier would be as low as 0.2-3. In other words, whereas a £1 increase in investment would raise total economic output by £1.30, a tax hike on high earners would reduce economic output by a mere 30 pence.

Corona virus: not all news is bad

Markets are starting to shrug off some of their earlier corona virus concerns. According to the World Health Organization, the number of confirmed new coronavirus cases has edged lower in the last few days from its peak of c4000 cases a day on 5 February. With c2500 cases yesterday, it reached the lowest number since 1 February. Of course, we economists cannot judge how the pandemic will develop. We have to brace ourselves for some further bad news. The impact of the partial standstill in China on supply chains will likely become ever more visible in coming days. All we can say at the moment is that the newsflow does not contradict our view that, outside China/East Asia and some heavily affected sectors linked largely to transport and tourism, the losses for Western economies will likely be modest and mostly temporary. Many of the current or upcoming hit to industrial production can probably be recovered once supplies from China become available again or companies have made alternative arrangements. So far, we do not see the pandemic as a reason to change our overall calls. The virus may retard the modest upturn in global trade and manufacturing output which we predict to unfold from Q2 2020 onwards. But it seems unlikely to derail it.

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