Quarterly Report on the Economic Environment

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GLOBAL ECONOMIC ENVIRONMENT Fourth Quarter 2019

Introduction

In this second global economic environment report, published quarterly since last Autumn, we review the fundamentals - and weaknesses - of the moderate improvement observed in recent months, albeit in confidence indicators rather than in the data, with respect to the immediate trajectory of the global economy.

In the first section of this Quarterly Report, *Economic Climate and Trends*, we will identify the factors upon which this improvement is based and the evolution of the principal elements that define and/or determine the global economic environment. The second section, the *Ten-Point Analysis*, analyses, precisely and concisely, the most significant processes and data from recent months and the decisions and expectations in relation to macroeconomic policies that influence the global economic situation. Finally the section *Under the Microscope*, aimed at shedding light on some of the events and processes that affect the international economy beyond the short term in more detail, offers a reflection on protectionism, its intensification over the last decade, and its implications.

Economic Climate and Trends

Determining factors	Current quarter		*Previous quarter*	
	Status	**Trend**	*Status*	*Trend*
Economic activity		**Positive**		*Negative*
Trade and exchange tensions		**Positive**		*Neutral*
Monetary policy		**Expansionary**		*Expansionary*
Fiscal policy		**Neutral**		*Neutral*
Commodities markets		**Neutral**		*Neutral*
Geopolitical tensions		**Negative**		*Negative*

Understanding the Economic Climate and Trends Chart:

a. **Economic climate**: defined for each of the determining factors as of the time of writing using a colour-coded scale from the most negative negative/contractionary level for the performance of the world economy (red), up to the most positive/expansive (blue) in the following order:

b. **Trend**: indicates the projected performance, from the time of writing and in the short term (forthcoming 3-6 months), for each of the determining factors, as either positive/neutral/negative (expansionary/neutral/contractionary in the case of macroeconomic policies)

c. **Determining factors**:

1. Economic activity: assessments based on the latest activity and confidence indicator measurements (World Bank industrial production index; IFO, ZEW, Tankan, Chicago ISM and various PMIs).

2. Trade and exchange tensions: evaluations based on the latest World Bank Merchandise Trade Index and Trade Policy Uncertainty Index measurements (calculated by Economic Policy Uncertainty) accounting for protectionist/free trade oriented measures offered in the Global Trade Alert, and the measures and statements which could be considered exchange rate manipulation by the major countries in the global economy.

3. Monetary policy: assessments based on the weighted global interest rate of the world's major central banks (accounting for about 77-80% of global GDP), and the movements in the reference rates they set in the six months prior to the publication of the report. Forward guidance implemented by managers of these central banks is also considered.

4. Fiscal policy: assessments based on the fiscal position and the ability to implement expansionary

fiscal policies of the world's 40 major economies, with a joint weight of 88% of global GDP between them and individual weight of at least 0.4% of global GDP. Data from the International Monetary Fund's Global Fiscal Monitor database.

5. Commodities markets: assessments based on the latest data from World Bank Commodity Price Data, with five major indices including up to 72 commodities, as well as the events that may significantly alter the behaviour of basic commodity prices in the short term.

6. Geopolitical tensions: assessments based on the latest data from the World Uncertainty Index, (offered by Economic Policy Uncertainty) and events and statements likely to significantly affect the international geopolitical context, potentially significantly affecting the global economy.

Ten-Point Analysis

I. Since our last report, there has been a favourable review of expectation for the global economy over the coming quarters. In reality, the change has been moderate and the general outlook, backed up by the latest data, for 2020 remains one the deceleration of the already modest growth of recent quarters, with certain geographic areas, from Latin America to India, where this weakening could be even more acute. Nevertheless, according to most analysts, the likelihood of the deceleration turning into a recession has reduced. Our Economic Climate and Trends chart illustrates this change in the improvement of Trends for a number of the variables considered, although we do not view these improvements as sufficient to amend the colours indicating current status.

In general, there are two fundamentals supporting this more favourable outlook on the immediate future. Firstly, we have observed a certain relaxation in commercial tensions, particularly between the United States and China, as geopolitical tensions have stabilised.[1] The second reason relates to the solidity of domestic consumption in Western economies, supported by low unemployment rates, a certain acceleration albeit modest in salary growth and the ease of obtaining loans at very low interest rates.

II. In relation to the reduction of commercial tension, there are a number of points to consider. Firstly, this change is particularly beneficial to Europe, being unique among the principal economic areas in that it is the most open to the rest of the world and the most dependent on trade. The Eurozone alone is responsible, according to data from the International Monetary Fund, for 26.5% of the total value of goods and services exported globally (while its economy, in terms of purchase power, accounts for 11.4% of global GDP). The figures for the United States (10.1% for exports and 15.2% for GDP) and China (10.7% and 18.7% respectively) indicate more closed economies that are less damaged than Europe by global commercial tensions.

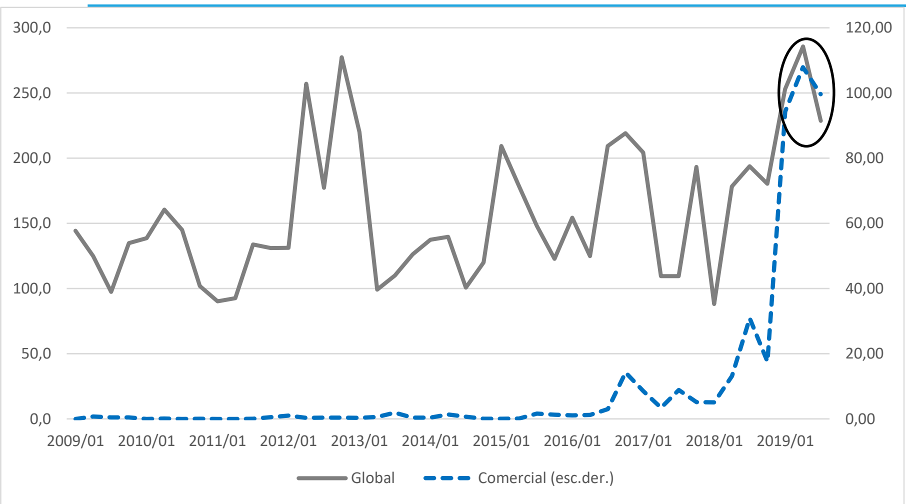
The second point refers to the fact that even though the media and even the indicators designed to the effect (see Figure 1) echo that improvement after a period of strong growth in tensions, both linked to trade and to the global geopolitical situation, exhaustive accounting of protectionist and liberal measures by Global Trade Alert does not reveal this improvement (see Figure 2) in the last quarter of 2019, but rather the opposite. Therefore, the undoubtedly revealing “first phase” of the commercial agreement between the United States and China, beyond its ostensible limitations, does not constitute a general pattern, at least not for the moment. In fact, it is more about not increasing, rather than reversing, the protectionist measures of past quarters and no changes are observed in the more solid reasons for US complaints about China's commercial and investment behaviour (see the *Under the Microscope* section for further detailed analysis).

In reality, and it is not surprising given the relevance of trade for the European Union, it is likely that the best result for trade liberalisation since 2019 is more down to the freed trade agreements already in force or pending ratification between the EU and Mercosur, Japan, Singapore and Vietnam. But none of them correspond to the final quarter of the year.

Note that, as we shall detail again in the third section of this Report, many of the measures restricting trade (and, to a lesser extent, foreign investment) that have been articulated on a global level over the last two or three years, are more linked to political or strategic, rather than economic, factors and it is precisely for that reason, if what is politically “advantageous” changes, it is possible some of these measures are reversed as quickly as they were introduced.

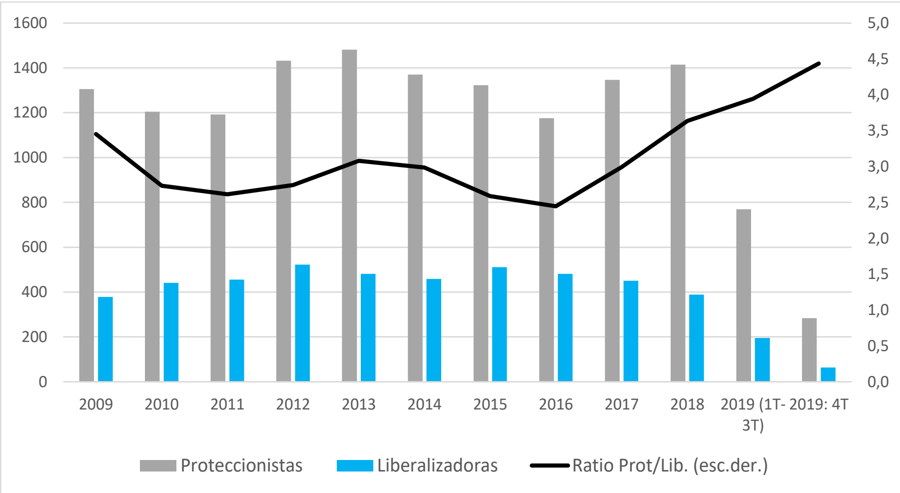
Figure 1. Trajectory of Global Uncertainty Index

[1] When it comes to preparing these lines, a United States attack on Baghdad airport causing the death of high-ranking Iranian general, Qassam Soleimani which in all likelihood, will seriously inflame tensions in the Middle East. That forces us to maintain our negative trend projection for geopolitical tensions, having hoped to include a neutral assessment in this Report.



Source: own calculations Data: Economic Policy Uncertainty

Figure 2. Evolution of market-opening and restrictive measures in relation to international trade



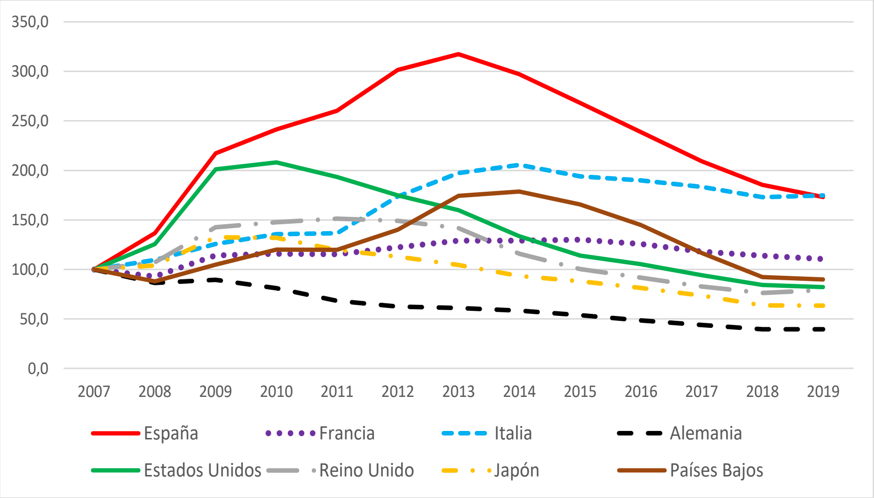
Source: own calculations Data: Global Trade Alert

III. In terms of the solidity of growth in consumption among families (we must not forget that private consumption is the most important component of GDP in western economies by some difference), this is down to the positive performance of the labour market, almost total stability in the prices of goods and services and the ease of access to credit and very low interest rates As for labour markets, aside from southern Europe, unemployment rates have recovered to (or surpassed) the levels from before the Great Recession (see Figure 3), something we have also seen in employment rates, with some delay, and to the extent that a disheartened population has returned to the labour market, in employment rates. In addition, the last critical variable to support the economic recovery, salaries, for which a lack of dynamism in the years after the crisis has been the subject of many debates, seems to be experiencing greater growth recently, at least in countries with lower rates of unemployment (see Figure 4 and Table 1).

All told, and in relation to this performance of salaries, weak progress in productivity in much of the West does not bode well for future growth. Furthermore, recent macroeconomic improvements in terms of salaries reveal notable disparities between groups of workers, with the least qualified marginalised and a significant fraction of the growing contingent of jobs in the so-called “gig economy” offering more unstable discontinuous employment than traditional jobs.

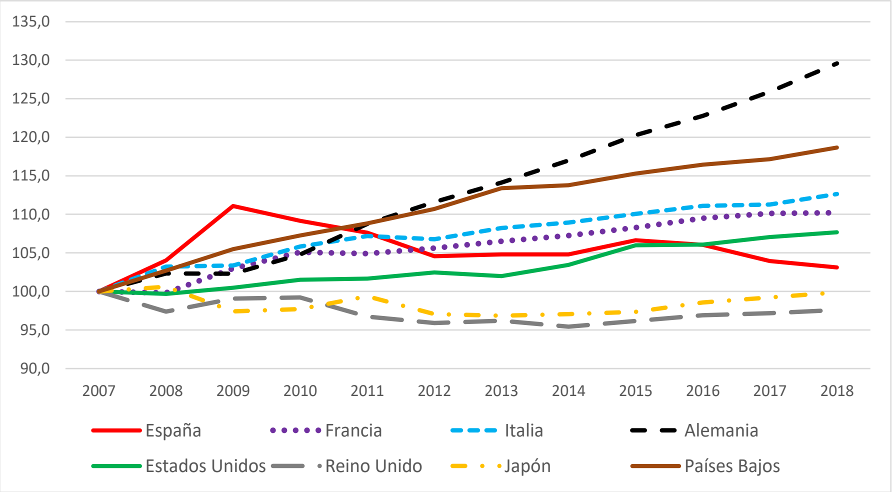
In relation to cheap credit, which also contributes to this robust progress in consumption, interest rates are not expected to rise over the coming quarters, and it is positive to note that household debt has reduced consistently since the Great Recession, although still not to the levels of before it. It must not be forgotten that this reduction must be due in large part to the low costs of servicing that debt.

Figure 3. Trajectory of unemployment rate (year 2007 = 100; selection of developed countries)



Source: own calculations Data: International Monetary Fund

Figure 4. Unemployment rate (year 2007 = 100; selection of developed countries)



Source: own calculations Data: OECD

Table 1. Variation in real salaries (measured in domestic currency, annual average; %)

	Germany	Spain	United States	France	Italy	Japan	Netherlands	United Kingdom
2000-2007	1.6	0.1	1.2	1.2	3.0	-0.9	3.2	2.4
2011-2018	2.5	-0.6	0.8	0.7	0.7	0.1	1.2	0.1
2016-2018	*5.5*	*-2.8*	*1.5*	*0.7*	*1.4*	*1.3*	*1.9*	*0.7*

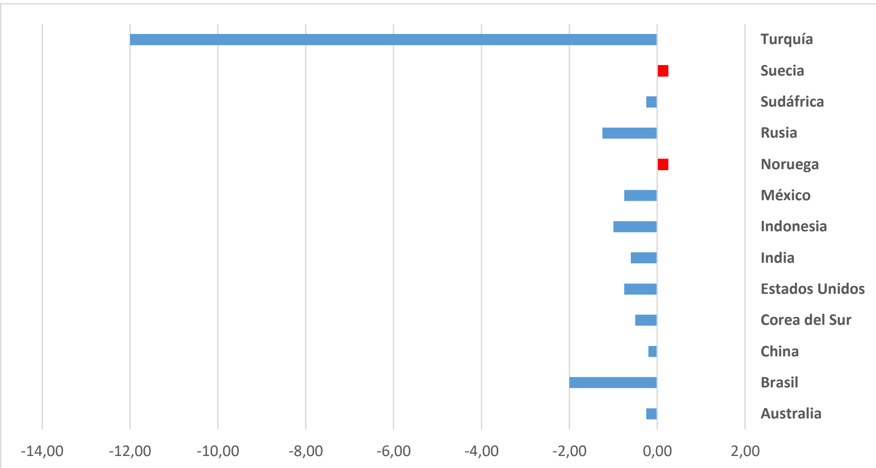
Source: own calculations Data: OECD

IV. In light of the above, why has the prospect of a global economic slowdown not been further allayed? In terms of our Report, should we not improve our assessment of economic activity at least from the fourth level to the third and not just point to a more positive trend? The answer to both questions is no, based on the fact that the global economy, in particular the West, is experiencing a unique, and in the medium term unsustainable, dichotomy. On the one hand, consumption and consumer confidence, the labour market and the services sector are showing signs of optimism. Against that, however, the manufacturing sector is in recession in a number of developed countries (and is not in the best of health in much of Asia, including China). Productive investment is on the wane or stagnant in the same OECD countries (including the last two quarters in the United States, where tax cuts for companies do not appear to have worked in their declared aim of improving investor commitment, and have only served to increase dividends and buy-backs to please shareholders), and the confidence of business managers is moving in a much more pessimistic direction than consumer confidence.

As stated, it is not possible to maintain this dichotomy. Either consumption drags the rest of activity upwards with it, or the prolonged weakness of manufacturing pervades the services sector through companies (and trade in particular) and, through the destruction of employment, brings an end to the household consumption bonanza. The fact that the latest IMF *World Economic Outlook,* published by an institution with a record of consistently getting it wrong over the last decade (and that is no exaggeration) by overestimating growth projections, leans towards a predominant downside risk with regard to the resolution of this imbalance, cannot but lead to a prudent outlook. Of course, in this report, readers will have already found reasons for that, and will continue to do so, beyond the projections of the IMF.

V. Exceptional expansionary monetary policy remains the central factor supporting economic growth. Even though a certain number of analysts have been signalling for some time that the limits of the contribution central banks can make to growth had been reached, and despite the general agreement that a repetition of certain expansionary measures would have the opposite effect, two counterpoints must be made that explain new doses of monetary stimulus (see Figure 5). Firstly, even though the degree of expansion in the West is unprecedented, the margin is significant in a number of emerging countries, by simply reducing interest rates with no need for unconventional policies Insofar that inflation levels in some of these economies (Turkey, Brazil, Russia) are at more acceptable levels than in previous years or are not accelerating in countries with recent problems of scant or shrinking growth (India, Mexico) further reductions in interest rates can be expected, in addition to those shown in Figure 5. On the other hand the imagination shown by some stakeholders, obviously not disinterested, in finding (relatively) new forms of unconventional monetary policy (from central banks setting dual rates, one for lending and one for deposits) to the massive asset purchasing schemes or the conversion of monetary authorities into fundamental supporters of the "green economy") indicate, perhaps, that monetary expansion has not reached its limits, even in the West.

Figure 5. Changes in the main central bank rates (second semester 2019)



Source: own calculations Data: Central Banks

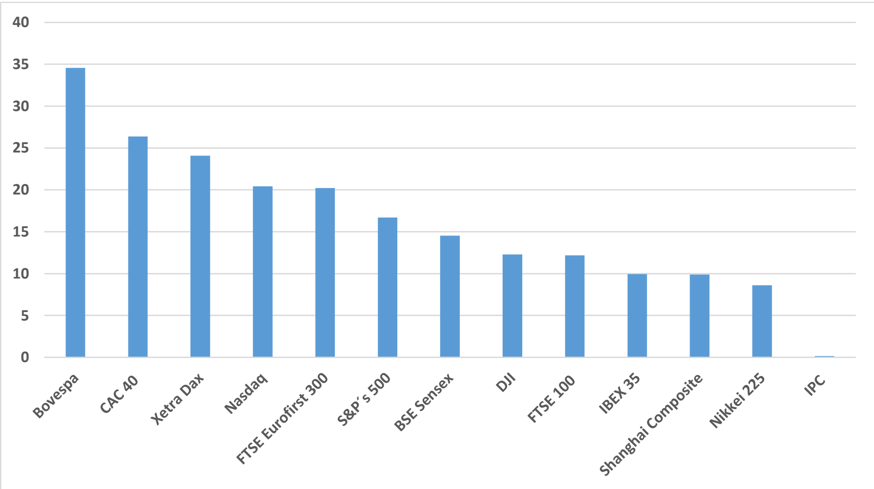
But in recent months, many central bankers, led by Christine Lagarde the new President of the European Central Bank, seem more committed to inducing governments to use their margin for fiscal expanison than redoubling monetary stimulus. Why? Because the fact that the limits of monetary relaxation have not been reached does not imply that there is not greater risk the longer it is prolonged and accentuated, with special mention for the setting of negative interest rates, for example. To use a term that has become popular in economic analyses of late, it is possible that the "reverse rate" has been reached; the point at which maintaining or reducing interest rates has a more contractionary than expansionary effect on the economy.

In fact, without doubt, the news on monetary decisions from the last quarter was not about reductions but the minimal increase of 25 basis points introduced by Sveriges Riskbank, the Central Bank of Sweden, on 19 December, to bring the reference rate back to 0. The decision was a controversial one given that Swedish economic growth is modest at present and inflation remains under control. It was motivated explicitly by the costs of maintaining negative reference interest rates, which had stood below 0 since February 2015.

Given the importance of these questions to recent, current and future economic growth, we hope to dedicate our *Under the Microscope* section next quarter to a more detailed analysis of these issues.

VI. The continuation (in reality, accentuation) of lax monetary policy and a certain relaxation of political tensions gave financial markets a considerable boost in the run-in to 2019, an exuberant view among the more optimistic observers that the global slowdown is coming to an end. In effect, as can be observed in Figure 6 the principal international stock markets have, with the exception of Mexico’s, all grown at considerable to exceptional rates in 2019, despite the serious doubts regarding the health of the global economy. In parallel the spike in yields in the public debt market is notable, with “only” 11 billion dollars of live debt at negative rates remaining (compared to 17 billion just a few months ago). Although part of this reduction of the volume at sub-zero rates is due to sales at the end of the year to improve profitability (remember that lower prices are equivalent to higher interest rates) an increase in medium to long-term profitability (with the resulting increase in the gradient of the curve, given that short-term rates have been anchored at close to zero) must be understood as a more optimistic perspective on the future performance of the economy.

Figure 6. International stock market indices (% variation in 2019)



Source: own calculations Data: Financial Times

Nevertheless, it should be remembered that part of that upward trajectory, particularly on Wall Street (which always has the effect of dragging other markets with it) is based on manoeuvres aimed at boosting the value of shares, even if only over the short term, by the companies themselves (increase in the payment of dividends and buy-backs of shares taking advantage of the Trump Administration's tax cuts). What’s more, this exuberance depends absolutely on the continuation of an extremely expansionary monetary policy, which can be discounted over the coming quarters, but not in perpetuity. Or can it?

In any case, the underestimating of the risks perceived in certain markets is worryingly reminiscent of what happened prior to the Great Recession. And let’s not forget that the new instrument added to the arsenal of macro-economic policies after that recession, geared precisely towards moderating such financial excesses and, in the absence thereof, the negative impact on the “real economy”, that is to say, macroprudential policy. It is neither tested nor does it have effective control over the “shadow banking system” (that which is outside the regulatory scope, centred on traditional banking) increasingly more apparent in current financial systems. It would be unwise to trip over the same stone twice, even if it has a different geological form and composition (to draw out the metaphor).

VII. Even though the incipient thawing of the atmosphere surrounding commercial relations with the United States has provided some relief for China (and boosting its stock markets at the end of 2019), the reality is that serious doubts persist regarding the Chinese government's capacity to strike a balance between the three dilemmas it faces at a time, let’s not forget, when the country is going through its lowest growth phase in three decades and has lost 17 million jobs in the secondary sector.

The first of the dilemmas is whether to maintain the rate of growth at around 6% per annum, but reversing the increase in low quality, high-risk loans, largely granted by a financial system that runs parallel to the large state banks and which, surprisingly for a country such as China, grew uncontrollably around the middle of the decade. In parallel with that it faces the difficulty of containing the tsunami of defaults of recent quarters on hundreds of private investment vehicles, modestly sized public companies and, more importantly

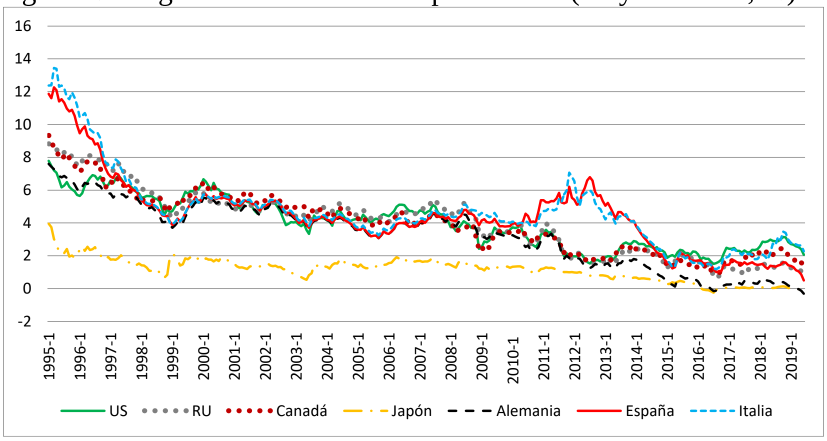
800 local governments. While the absolute sums in default are limited, the impact on investor confidence, both domestically and overseas, and on citizens in general is significant. Nevertheless, the effort to contain this adverse impact cannot prevent the appropriate response from the central government which is to leave those who chose a certain investment to assume the losses if it fails. Finally, since Xi Jinping's ascent to power in 2013, there has seemed to be a growing preference within the Chinese government to support the large public companies, especially in relation to access to, and the costs of, financing. However, the success of the Chinese State Capitalism model is due, in considerable part, to the development of the private sector. The country simply cannot allow the collapse of a significant part of this due to the lack of access to financing.

In this complex scenario China, which has a margin to do so, has launched a new monetary and fiscal stimulus package, focused on three areas: firstly, the strategic sectors for the country's future prioritised in the *Made in China 2025* plan; secondly, infrastructures that are deemed productive and that have been halted by the asphyxiating debt of numerous regional and local governments (not forgetting that China has invested significant sums since the late 00s in infrastructure projects that were hard to justify from a social profitability and/or future economic perspective); and finally, investing to extend healthcare cover for the population, which, aside from the direct impact on health, will allow them to increase consumption as it would make it no longer necessary to save as a precaution for potential unexpected healthcare costs. The property sector is unequivocally excluded from the stimulus programme.

Finally, it must be pointed out that this sprawling package, with a fiscal volume yet to be determined, accompanied by a modest reduction in reference rates of 25 basis points and more significant reduction of mandatory cash reserves for banks (which would allow for an increase in credit, especially to private SMEs) will, in any case, have a far smaller effect than the colossal 19% of GDP estimated for the expansionary measures adopted in 2008 or the 10% for those undertaken in 2015. And the problem of the untethered growth of excessive private and public debt over the last decade, together with defaults and bad loans, obliges us to view this effort to stimulate growth with some degree of prudence.

VIII. While China resorts to all resources available to prevent a further slowdown of its economy, fiscal policy in the West remains neutral, despite growing calls from experts and institutions for countries with the margin to do so (and the European Union as a whole) to commit to an expansionary line, favoured by the virtually zero cost of long-term financing which would be required, given current interest rates (see Figure 7). We already noted in our previous Report that there was a clear need to invest in physical and technological infrastructures, in strengthening our commitment to strategic sectors (5G, electric car batteries, artificial intelligence, new materials, renewable energies) and ensuring the best possible adaptation of workers and SMEs to the rapid changes in today's economy, all in a context that must ensure the environmental sustainability of the new production processes.

Figure 7. Long-term interest rates of public debt (10-year bonds; %)



Source: own calculations Data: FRED II; ECB

While it is likely that resistance to this fiscal effort will run out of road, for now, since our previous Report, there is only one fiscal stimulus programme in the West worth mentioning: the Japanese government has undertaken an extensive plan worth the equivalent of some 120 billion dollars focussed on strategic sectors. In any case, it is not the absence of fiscal injections that is keeping economic growth at tepid rates in Japan (rather, it is the lack of structural reforms on the part of the Abe Administration and aging demographics) and, in any case, it was implemented after VAT was raised 8% to 10%, a measure that is clearly contradictory in purpose.

IX. Commodities markets have proven to be quite stable throughout 2019, with a moderate general downward trend in prices, especially in relation to energy. As shown in Table 2, the overall volatility in prices for the principal commodity groups has, in the last year, been less than half the average in each year of the last decade. A stabilising factor for the economic situation. It is true that in the second half of the year and the last quarter in particular, as also demonstrated in Figure 2, there was a certain rebound in prices, especially energy (as a result of OPEC's capacity to sustain and prolong agreements for the voluntary restriction of crude production to maintain process) and foods, in this case due to the impact of the swine flu in China, which forced the sacrifice of 100 million pigs and led to a notable upswing in the price of pork, dragging the prices of other meats with it. For the minerals and metals group, only palladium thanks to its widespread application in electronic and technology products in general (and uniquely, in the era of concern around climate change, in catalytic converters for diesel and petrol vehicles) has seen its price soar in the commodities markets over the last year. None of that, however, changes the generally stable scenario for this group of commodities so essential to the global economy.

Table 2. Price trajectory of principal commodity groups

	Energy	Food	Agricultural raw materials	Metals and minerals	Precious metals
2007-2018	21.7	11.6	9.3	16.7.	13.2
2019	-12.7	-3.8	-3.8	-5.0.	8.5
2019: 2S	*2.8*	*6.0.*	*2.9*	*-4.4*	*5.3*
2019: 4T	*4.5*	*9.4*	*5.4*	*0.2*	*-2.6*

Note: Variations in the period 2007-2008 correspond to the annuals averages, taking the absolute change value for each year.
Source: own calculations Data: World Bank.

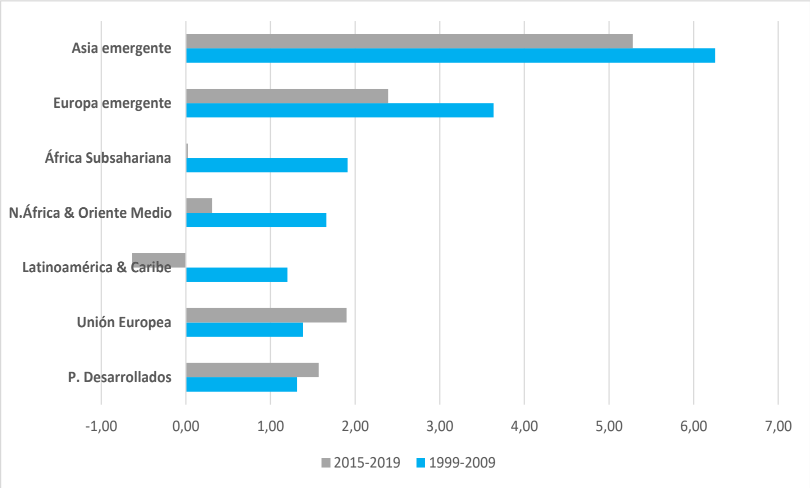
X. In the interest of keeping this *Ten-Point Analysis* reasonably short, it is not feasible here to engage in even a cursory exploration of the circumstances of most of the economic areas of the world. Nevertheless, it seems appropriate to close this analysis of the third quarter of 2019 with a reminder of what can only be described as the dramatic situation in Latin America. Over the last year, the trend of socio-political instability has intensified, this time with movements, either spontaneous and/or influenced from abroad, under governments with very different leanings expressed with a singular intensity on the streets. It is curious that, in the case of movements emerging spontaneously and influenced from abroad, many analysts who defend the latter where they agree with the government, vehemently reject same where the opposite was the case, evident in much of the analysis of events in Chile and Bolivia for example. Then there are inadequate economic policies, highly volatile and contradictory between one government and the next, a lack of interest in the situation of important groups of the population on whose part they take decisions, administrations of paralysis and deeply entrenched threats, with drug trafficking to the fore. It all makes for a desolate panorama.

So, when turning to the economic variable par excellence to measure a country's results, per capita growth, rather than in looking at it in absolute terms, and even ignoring the discussion of GDP or income distribution (the latter would make the situation even worse), we find, as displayed in Figure 8, that we are on course an aggravated repeat of Latin America's "lost decade" (1980s) from the middle of the 2020s. In effect, per capita income in Latin America and the Caribbean has fallen over the last five years. What's more, analysing the last two decades, growth in this variable has remained below European Union levels, despite the region, far richer to begin with, being widely considered the sick man of the world. With that, Latin America has experienced real divergence from the West over a prolonged period and constitutes a unique case among the large economic areas. Unfortunately, the data reveal that, if we focus on the last five years, this lack of convergence has also spread to North Africa and the Middle East and Sub-Saharan Africa. And speaking of economic growth, we not forget the demographics.

In any case, if the growth cycle in the wake of the Great Recession, and despite the discontent with growth in much of the West, has only served to bring about real convergence in the developed world of emerging Asia and emerging Europe,[2] the doubts already expressed in these Reports on the intensity and quality of that growth are even more justified.

[2] Note that the results for Emerging Europe are less favourable than those that would have been obtained up until the recent incorporation of Russia and Ukraine into this group by the IMF.

Figure 8. Real GDP growth per capita (annual average; %; PPP; international $ 2011)



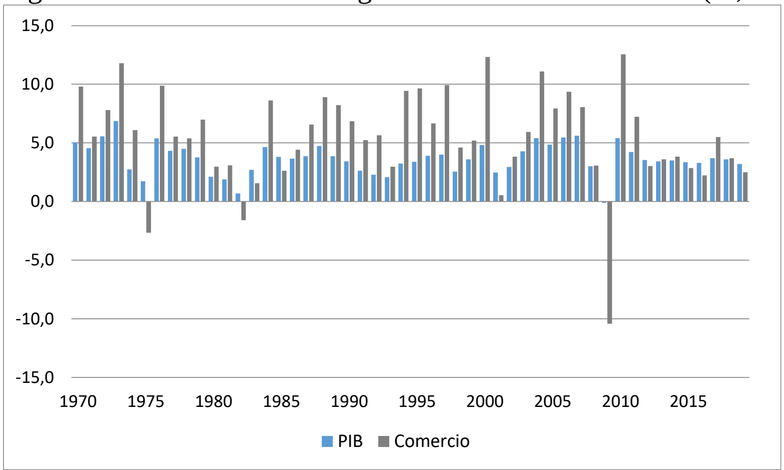
Source: own calculations Data: IMF

Under the Microscope
Protectionism: An Old and Useless Recipe

Back to the past... with no need for Donald Trump

There is a curious discrepancy between one of the few widely shared views among macroeconomists and the way in which many Governments act when the economic situation becomes complicated. In effect, the immense majority (consensus is not feasible in this sector) of macroeconomists attribute the unequivocally negative effects for economic growth to measures restricting international trade. The loss of the advantages of specialisation, of competition, the availability of primary inputs and better and/or cheaper intermediaries for final production and the spread of technologies and ideas, either directly through goods or services that are exchanged, constitutes a burden on economic growth, an obstacle to progress in production, greater increases in prices and reductions in well-being for most citizens. With all of that, at least from the end of the Second World War to the onset of the Great Recession, the world has advanced, through multiple international agreements and under the umbrella of the World Trade Organization (previously the Global Agreement on Tarrifs and Trade) towards a regime of significant (far from total) free trade, subject only the restrictions accepted by the sovereign stakeholders as a group and, in the absence thereof, subject to international arbitration. In this context, for decades and especially with the advancement in information and communication technologies (ICTs), and logistics and transport processes and instruments, combined later with the development of Global Supply Chains, international trade has grown robustly (slowed only in the short term in years of most severe economic crises) and, on average, doubling the rate of advance of the global economy (see Figure I).

Figure I. Variation of trade in goods and services and GDP (%, real terms; global economy)



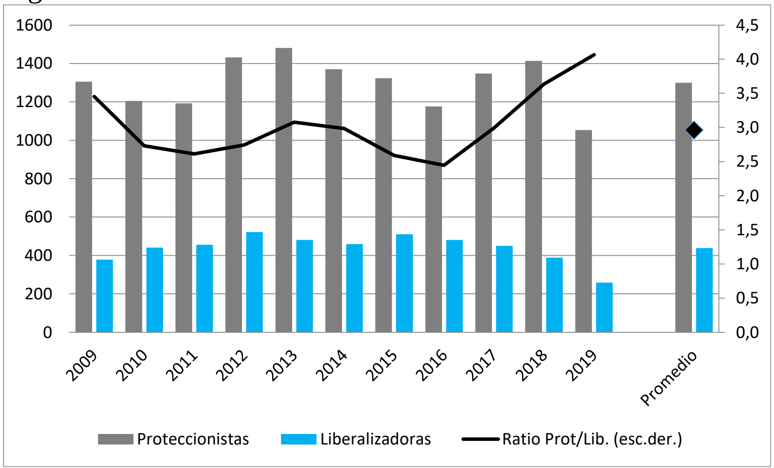
Source: own calculations. Data: IMF.

Conscious of the importance of trade as an engine of economic growth, it is remarkable how one of the messages emerging from meetings of world leaders at the G-20 in the years immediately following the onset of the last economic crisis focussed on a commitment to preventing an escalation of protectionism that would damage this engine at a particularly difficult time for the world economy. However, and recovering an old and pernicious custom of closing inwards at times of difficulty, measures restricting the trade of goods and services (as well as the movement of capital and people of course) began to spread, multiplying at several times the pace of those geared towards reducing barriers. Certainly the escalation hasn't reached the extremes of the wake of the Great Depression of 1929 and perhaps the most infamous protectionist measure of all time, the United States' Smoot–Hawley Tariff Act of June 1930. Maintaining this protectionist trend under a certain degree of control and the improved response to the crisis of macroeconomic policies, especially monetary, and the presence of economies outside the West, especially China, capable of driving global activity, were probably the keys to ensuring the Great Recession did not become another Great Depression. But Figure I also shows how, over recent years, global trade growth has barely reached the level of global GDP, even in a context where the latter has hardly been particularly dynamic.

Figure II illustrates how, between 2009 and 2019, according to the exhaustive collation carried out by Global Trade Alert, the annual average of protectionist measures (some 1,300) has tripled the number of free trade measures (on average, some 439). This trend, therefore, predates considerably the arrival of the Trump Administration and is aligned with the old recipe of “protect what's ours”, as classic as it is unfortunate, especially when everyone “protects what's theirs” in the event of economic crises, an inevitable response to the first signs of protectionist warfare.

It is true, nevertheless, that President Trump with his trade slogan of “trade wars are good and easy to win”, and displaying an ignorance of considerable dimensions, as we shall explain shortly, has marked a new phase in this escalation of protectionism. This has become more intense (the ratio of protectionist measures to free trade measures has gone from 2:4 to 4:1 between 2016 and 2019), and more strident (with a trend already underway from the beginning of the crisis only jumping to the front pages recently), has led first to impotence and then paralysis of the WTO and, finally, has seen the use of trade protectionism as a response to situations that, in reality, have nothing to do with the economy.

Figure II. Evolution of free trade measures and measures restricting international trade.



Source: own calculations Data: Global Trade Alert

Unequivocal data and unusual motivations

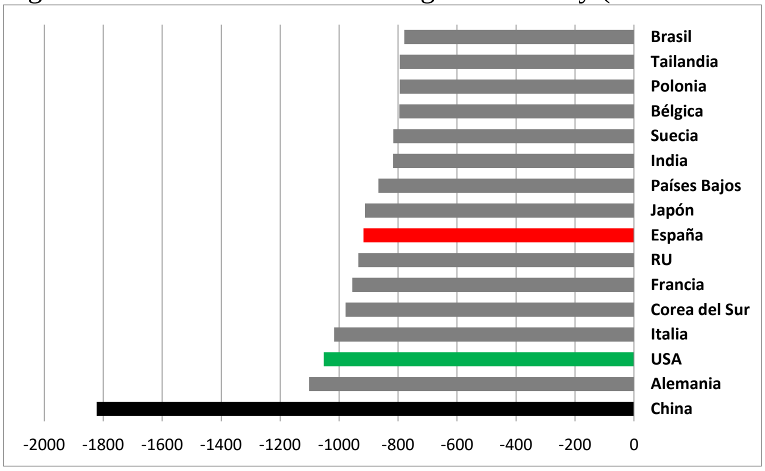
Before delving further into our qualitative analysis and assessment of this escalating protectionism, allow us to clarify a couple of details based, again, on the information from Global Trade Alert. On the one hand, in Figures III and IV we can observe that countries have been the primary parties responsible and also the biggest victims of this accumulation of restrictive actions over the past decade. As can be observed, for all the major economies, the number of measures hampering trade, imposed by members between 2009 and 2019, exceed the number of measure facilitating trade by several hundred. For example, for Spain the difference is 917 more restrictive measures than free trade measures. The worst balance is China's, with a difference of 1,822 measures, followed by Germany and the United States. It is telling, as an expression of the extent of the protectionist wave that only three countries show a net difference in favour of free trade measures (Monaco, South Sudan and French Guiana), which implies that even the poorest countries in the world are suffering from this trend.

On the opposite side, the United States is precisely the country that, by some distance, is engaging in the most marked exercise in protectionism: in eleven years it has imposed 629 more contractionary measures than expansionary measures; in net terms, India and Germany follow the United States. For Spain, the difference is 191 more restrictive actions than in support of free trade.[3] Note that China, consistent with its position in favour of free trade (although its concept of this term is, undoubtedly, a peculiar one), shows a

[3] The fact that there are many more measures suffered than implemented is due to the fact that, frequently, a single action of a country affects several and even multiple trade partners, something common with sanctions in particular. See, for example, the case of punitive measures authorised by the WTO to United States in the case of illegal European Union subsidies to Airbus. You can see the enormous quantity of European products affected at:
https://ustr.gov/sites/default/files/enforcement/301Investigations/Notice_of_Determination_and_Action_Pursuant_to_Section_301-Large_Civil_Aircraft_Dispute.pdf

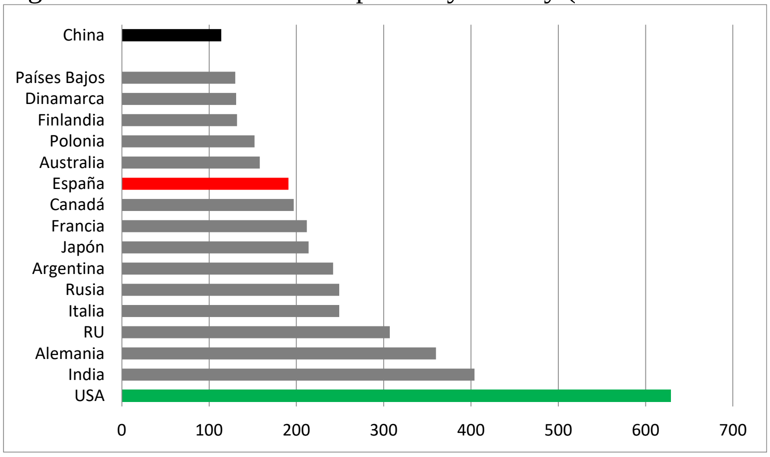
relatively contained net balance (114).

Figure III. Trade measures affecting each country (free trade – restrictive; 2009-2019)



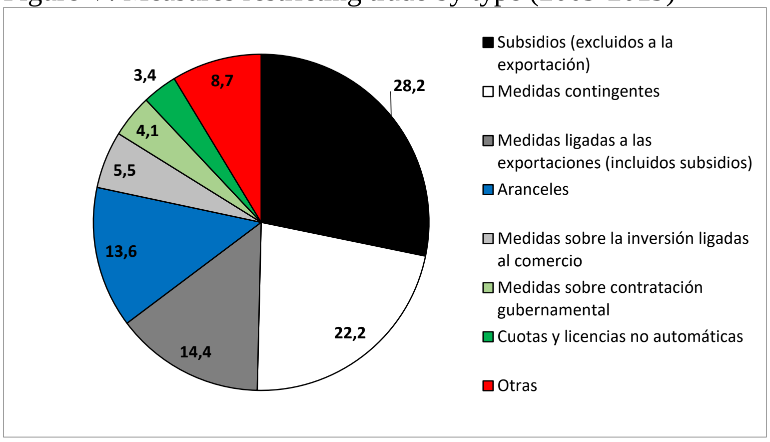
Source: own calculations. Data: Global Trade Alert.

Figure IV. Trade measures imposed by country (restrictive – free trade; 2009-2019)



Source: own calculations. Data: Global Trade Alert.

Figure V. Measures restricting trade by type (2009-2019)



Source: own calculations. Data: Global Trade Alert.

In terms of the instrument used most (Figure V), this was not tarrifs (occupying only fourth place in quantitative terms) but subsidies other than those fostering exports (therefore, those aimed at protecting domestic producers affected) followed by quantitative measures (quotas) and measures fostering exports, including subsidies.

To complete this more descriptive information, we previously noted how one of the most unique features of many of the situations that have led to the adoption of protectionist measures over recent years is that they are not even economic in nature (even it is clearly mistaken to do so, it is generally assumed that these restrictive measures have to do with economic factors). By way of example, we can cite the interference, potential or already already, affecting trade arising from the confrontation between Japan and South Korea due to the validity or otherwise of decades-old agreements relating to Japanese troops using Korean women as sex slaves during the Second World War; Australia's review of the alleged mistreatment of Chinese citizens/agents in the country's institutions; the sufficient collaboration (or not, according to Donald Trump) of Mexico in preventing Central American emigration towards the United States, the threats of sanctions issued by the United States in relation to the failure of a number of countries to meet the defence spending as a percentage of GDP agreed by members of NATO; Brexit; ideological discrepancies between countries or internal policy measures (Argentina/Brazil; EU/Mercosur based on the decisions of Brazilian Administration etc.).

While all of the above is unfortunate with regard to the damage to international trade and serves to increase uncertainty of economic operators in general, this twisting of the reasons for implementing protectionist measures has the advantage of perhaps proving simple to reverse (as has been considered in the last couple of month), because, in most cases, there are no lobby groups who support these measures, based on their own economic interests). In reality, and insofar as these are really ad hoc decisions arising more from the political opportunism of the moment, it is easier to prove otherwise just as arbitrarily.

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The inherent misguidedness of the protectionist wave

As has already been shown, protectionism constitutes a direct attack on the process of specialisation (and with it advances in productivity, price containment and stimulus of economic growth) arising from the comparative economic advantage of different economic areas. In particular, and at the present time, it interrupts the Global Supply Chain that sustains a very significant part of global economic activity invalidating the enormous resources invested in it and the international logistics and transport processes that sustain it. But, furthermore, this strong protectionist drift:

I. Opens the door to a circle of successive reprisals as it is highly unlikely that a country or group of countries is willing to suffer unjustified protectionism without adopting similar measures.

II. Introduces levels of uncertainty than undermine economic growth especially through lower productive investment (a worrying trend already referenced in our *Ten-Point Analysis*.

III. Is intended, at least conceptually, as a response to two ideas, already myths that are deeply flawed.

The first states that current account deficits are unequivocally negative. But, in reality, as shown in the Annex at the end of this document a current account deficit is but a reflection of an excess in domestic investment drive over domestic savings, an excess that is financed by foreign capital. It is absurd to understand such a process as a negative phenomenon where this capital is used in productive investment, growth and the creation of employment is accelerated compared to the alternative in the absence thereof. Even considering the interests/dividends paid in return for these capital investments, the receiving country will be much richer than before this injection of foreign savings. Of course, if these funds are squandered on luxuries or feeding property bubbles, for example, the country will indeed find itself facing a serious problem in the medium term. But this is not necessarily consequence of current account deficits, but rather of the deficient economic management of the country.

So if a country, let's say the United States, wants to reduce its foreign deficit, the way to do is by increasing internal savings, something that would hinder the fiscal measures of the Trump Administration. On the contrary, if another country, let's say China, seeks to reduce its current account surplus, it should foster consumption. And that is exactly what the new Chinese economic growth model, in place since the middle of the decade, is seeking. In fact, China's current account surplus, which reached 9.9% of GDP in 2007, fell by 0.4% in 2018 (for the avoidance of doubt, it was already at 1.8% when Donald Trump took over the Presidency).

The second great myth of current account deficits is the claim that they reveal serious problems in relation to competitiveness for a country and its companies arising from abusive behaviour on the part of trading partners ("they're stealing from us").

Once again, this is an absurd argument. The deficit simply reveals and excess of demand over production (see the *Annex* here), and is a consequence of the spending behaviour of the public and private economic operators of a country, regardless of the parameters determining competitiveness, both in terms of price (exchange rate, labour costs, other costs, productivity) and quality (international expansion strategies, design, patents, productivity again) of the companies in the country. It would be difficult to consider the US economy and its companies to be poor in terms of competitiveness, but for the last two decades the United States has had the highest current account deficit in the world. And that is to do with a manifest excess of consumption in its domestic economies (and, to a lesser extent, the Federal Government), not problems with competitiveness. Of course, the United States cannot be expected to be competitive in all activities. For example, in intensive manufacturing employment, simply, and as we shall show later, regardless of the degree of protectionism established, no US worker is going to work at the rate of salaries paid for these activities.

On the contrary the latest data available from the International Monetary Fund reveal the five countries with the largest current account surplus in relation to GDP are Macau, Papua-New Guinea, Brunei, Singapore and Azerbaijan. It doesn’t seem feasible to claim that these countries are extremely competitive (with the exception of Singapore, in very specific activities) whose companies are stealing market share from US companies.

Of course, that such a relationship does not necessarily hold true does not mean that it is never the case, and there are also weakly competitive economies with major deficits (Mozambique or Niger at present, or Greece at the time of the outbreak of the last crisis) and there are very competitive countries with major surpluses, such as Germany and the Netherlands.

The futility of the protectionist wave

In parallel with the significant costs and a lack of solid foundations to sustain the current protectionist drift (and as occurred with previous ones), there is the fact, even more convincing in practical terms, of its evident futility in achieving its objectives of reversing external balances. There are a number of reasons for this:

1. Firstly, we must stress that the lack of arguments behind many of the protectionist measures of the last decade does not imply that international trade itself works like a Swiss watch, with the utmost respect for WTO rules and without the development of actions that seek unfair advantage in trade relations. The fact that China is behind a considerable number of such objectionable actions cannot be ignored. Without doubt, this is one area where the Trump Administration should be praised: the forceful revelation of certain openly irregular practices long engaged in by China, such as: forcing the transfer of technology from international companies to local partners as a requirement for operating in the Chinese market; intellectual property violations; abusive restrictions of access to public contracts for foreign companies; preventing foreign operators from investing in certain sectors (restrictions out of step compared to those for Chinese companies overseas); public subsidies, including advantageous financing, to facilitate exports and/or taking positions in the financial markets.

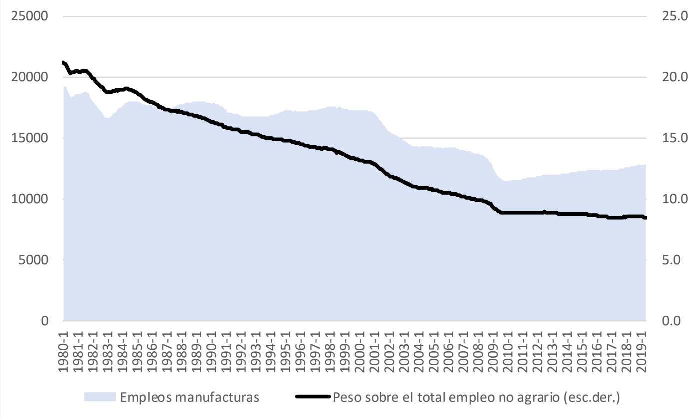
But all of that should be addressed on a multilateral basis (the European Union or Japan would no doubt support the United States in denouncing such behaviours), within the WTO where, moreover, the United States usually wins any litigation in undertakes. However, mixing reasonable demands for the correction of these behaviours with rants on currency manipulation, current account balances or “threats to national security” removed all efficiency - and support - from US denunciations.

Logically, the above applies to any analogous situation in the world economy beyond the specific actions of China.

2. The Western manufacturing sector, and the US one in particular, will *not* recover the employment of previous decades, which has been falling, in line with what economic theory predicts, for some time (see Figure VI), with employment rising in the services sector, frequently in fact in pre and post-manufacturing activities.

Certainly, it is expected that developed countries will continue to maintain a rate of industrial employment, key in terms of productivity and a catalyst for the whole economy (and the export sector), taking advantage of human capital, technology, environment for the generation of ideas and institutional stability. But the prospect of a massive “re-shoring” (that is, the return of jobs that, in search of lower costs and/or new markets, moved to the emerging world over the last quarter century) is simply not credible. In this regard, the oft-cited report by Boston Consulting Group claiming that between 300,000 and 400,000 jobs could have returned to the United States by the end of the decade must be kept in perspective. This figure, spread over ten years (a gross figure, it does not include newly displaced jobs), it must be read in relation to the 155 million existing jobs in the country, with an aggregate ratio of hirings and layoffs of 7.5% (11 and a half million jobs *per year*) with 560,000 net jobs created on average *per quarter*. In other words, re-shoring is a drop in the ocean, the fruit of specific decisions of companies that, on an isolated basis, consider that, largely due to problems in their global supply chains or the reduction in energy costs in the United States, it would be profitable to return home. This is a dynamic of the market economy and not a trend that with alter the reality presented in the graph above.

Figure VI. Trajectory of employment in manufacturing sector in the United States



Source: own calculations. Data: FRED II.

3. Finally, the protectionist outbursts that seek to alter the balance of payments usually end up an ostensible failure, even where they serve their direct objective, beyond the aforementioned problems they bring. Not only does such friction tend to reduce the level of trade between the countries involved in the “trade war” but it leads to a diversion of trade toward third countries that, offering productive capacity and similar competitive advantage to the country punished by protectionism, replace it as supplier to the country applying those penalties.

Table 3. United States imports from selected countries (difference over the period 2017:1-2017:10 and the period 2019:1-2019:10)

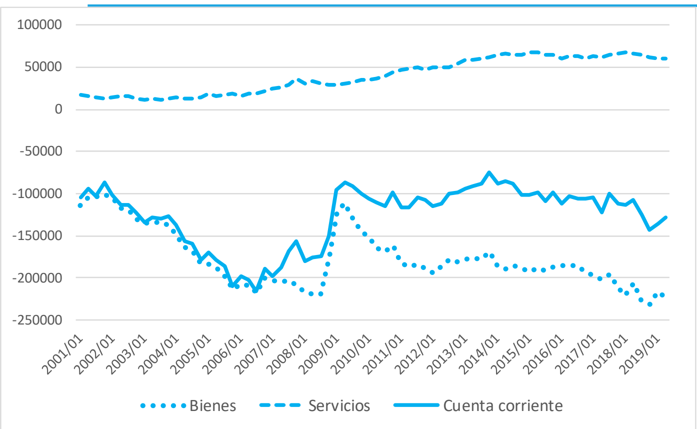
	Exports from the US to China	Imports to the US from China	Imports to the US from Mexico	Imports to the US from Vietnam	Imports to the US from Malaysia
Variation	-15.3%	-7.4%	+15.8%	+42.9%	+8.6%

Source: own calculations. Data: FRED II.

Table 3 shows the evolution of purchases and sales between China and the United States in the year 2019 (up to October, with the data available) with respect to the same period two years before, when the protectionist measures of the Trump Administration and the Chinese responses had not yet occurred. It also shows the trajectory of US imports for the same period from countries that can benefit (and in fact, as can be seen, are doing so) from this diversion of trade.

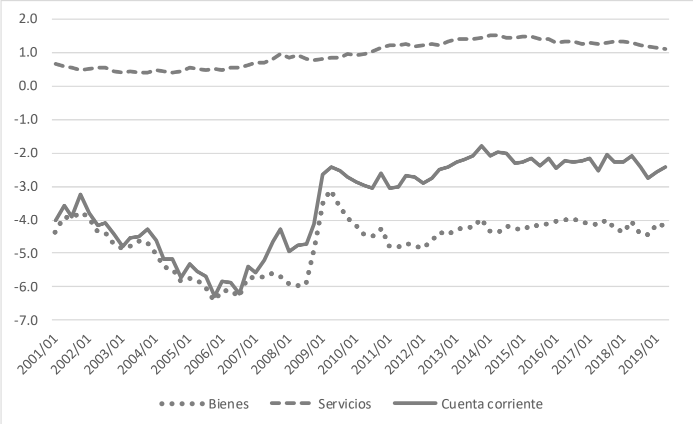
The results are telling: a fall not only in US imports from China but also, and to a greater extent, in exports. There is a notable (enormous in the case of Vietnam) increase in exports to the United States from producer countries. And the result in terms of foreign trade balances, which are so important to the Trump Administration? Figures VII and VIII reveal that nothing has changed (if anything there has been a slight deterioration) in absolute terms or in relation to GDP in the foreign trade balance trends of the United States. That's a lot of baggage for such a short journey.

Figure VII. US trade balances (millions of US $; quarterly data)



Source: own calculations. Data: FRED II.

Figure VII. US trade balances (as a % of GDP; quarterly data)



Source: own calculations. Data: FRED II.

Ultimately, protectionism is a fallacious recipe in the long tradition of trying to correct complex economic situations and punishing partners who are alleged to have "robbed", "cheated" and "abused" the country that opts for this strategy. Where the measures spread and are applied generally, which is common where a large economy sets the tone, the costs to economic growth are considerable, without even bringing about the ends that, a priori, were supposed to justify such means. In a bleak economic situation such as 2019's and which is set to persist in 2020, these processes are especially pernicious. It is to be expected that, given that it is a harmful, mistaken and futile approach, we might soon see a reversal in this increase in protectionism. The world economy would certainly appreciate it.

ANNEX

Let's consider an economy, in the absence of foreign relations, which has access to certain resources from domestic production (Y). This production can be allocated to the satisfaction of current wishes or needs, that is, private sector consumption (C) and public sector consumption (G) or obtaining future assets or non-residential investment (NRI) or to acquire residential property (RI). That provides us with a formula that is merely an accounting identity, that is true for any economy:

$$Y \equiv C+G+NRI+RI \ (1)$$

Obviously, no economy lacks foreign relations, therefore we should extend this formula to include a new source of resources, what we buy overseas (imports, M) and a new use for resources, what we export to the rest of the world (exports, X). So, we can allocated our production (Y) to exports (X) as well as the aforementioned uses (C + G + NRI +

RI), but at the same time, part of our consumption, private or public or of the investment can be satisfied via the acquisition of goods and services from abroad (imports, M). Leaving us with the following formula:

$$Y+M \equiv C+G+NRI+RI+X \ (2)$$

In short, it is common to combine all uses consisting of consumption and investment internally in a single term, absorption[4] or internal demand (A), leaving us with

$$Y+M \equiv A+X \ (3)$$

So to use the same formula, rearranging that terms we can state:

$$Y-A \equiv X-M \ (4)$$

That means that the balance of foreign trade of an economy (X-M) is necessarily the difference between production and internal demand (Y-A). Therefore, a current account deficit[5] implies that domestic demand within the economy (consumption plus investment) exceeds the production. This difference is covered with an excess imports over exports, resulting in a foreign trade deficit.

We then proceed to introduce savings (S) into the equation. By simple definition, the production of an economy is either consumed or saved. To differentiate between different types of consumption, private and public, we have:

$$Y \equiv C+G+S; \text{ therefore, } S \equiv Y-C-G \ (5)$$

Therefore, based on (2) and (5) we can state:

$$Y+M-C-G \equiv NRI+RI+X; \text{ therefore, } S+M \equiv NRI+RI+X; \text{ and } S-NRI-RI \equiv X-M \ (6)$$

This formula shows us that the foreign balance of trade of an economy (X-M) is aslo, necessarily, the difference between savings and investment, residential or non-residential, of the economy (S-NRI-RI). Therefore, a current account deficit implies that a country's savings are not enough to finance the investment in the country. Therefore, the economy in question requires access to the savings of the rest of the world to cover the difference.

Given that this is an accounting identity, a country with a current account deficit is experiencing an excess of domestic demand over production and insufficient savings with respect to investment. These two domestic imbalances are parallel to the external one and the three are covered from the rest of the world, which finances such imbalances by providing savings or net capital inflows. In economic terms, a financial account surplus occurs (a country's capital inflows exceed capital outflows). A current account deficit and financial account surplus, therefore, are two sides of the same coin. Therefore, the contrary occurs in those countries where there is an excess of savings with respect to investment and production with respect to domestic demand.

[4] *Commonly referred to as the "absorption approach".*

[5] *The exact term would be a current and capital account deficit*

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