



# Quarterly Report on the Economic Environment

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## GLOBAL ECONOMIC ENVIRONMENT Second quarter 2020

### Introduction

The consequences of COVID-19 continue to determine the international economic landscape. After a first quarter of 2020 that will go down on record as the worst ever in terms of economic growth (in peacetime), particularly as a result of the impact on developed countries, our attention turns to three key issues: the pace of an economic recovery that is beginning to be felt, the potential spread of the seriousness of the crisis to regions less affected in the first half of the year and the repercussions of a more structural nature that will be the true economic legacy of the pandemic. All of this, of course, comes with the uncertainty of not knowing the extent to which, if at all, the SARS-CoV-2 virus will again wreak the individual and economic devastation caused in recent months in a potential future wave.

In the first section of this Quarterly Report, *Economic Climate and Trends*, we'll summarise the situation at the end of the first half of 2020 caused by the impact of the coronavirus and the response to it from private and, in particular, public leaders. In our Ten-Point Analysis we'll review the most important elements that define the state of world economy at this time, with a special focus on the expansionary monetary and fiscal measures accumulated over recent months, and the reversal in negative trends that began to be felt from May on in a number of sectors (not all) of the global economy. Finally, our *Under the Microscope* feature section looks at one of the structural legacies of the pandemic that will condition the future over coming years or even beyond: how to tackle exorbitant public debt which, already at an excessive level before the outbreak of the crisis, has risen to unprecedented levels in the response to it. We'll provide the data and analyse the variables upon which the sustainability of these fiscal measures depend. We'll look at how similar excesses have been corrected in the past and we'll try to respond to the reasons why, confronted with an extremely high accumulated level of public debt, most political economists and financial market operators appear less concerned than at previous times when debt wasn't even approaching the heights set to reach by the start of the 2030s.

## Economic Climate and Trends

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

### ***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/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 (or 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 world 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. The COVID-19 pandemic, as we already anticipated in our previous Quarterly Report, has led to an economic crisis as exceptional in its magnitude as in the speed of its propagation. Although the focus of the response at all levels of macroeconomic policy, something we shall return to presently, has also been unprecedented in terms of its extension and the innovative formulas applied in some cases, the estimates of the impact on the global economy, especially, but by no means only, in developed countries, have been repeatedly reviewed upwards since the first estimates were hurriedly prepared at the start of the second quarter. As shown in Table 1, the fall-off in global GDP in 2020 is estimated at around 5-6% with substantially higher figures in the advanced economies, especially in Europe. In many cases, supranational the principal economic bodies are expecting double digit reductions in GDP. Even more dynamic emerging economies in Asia are set to experience a fall-off in activity or in the very best of cases stagnation. The final column in Table 1 summarises the OECD estimates in the event of a significant global second wave of the pandemic. Even with a rapid and precise response, both medical and economic, to a potential second wave of the virus, the intensification of the drop in GDP would be notable (an additional 30% if use the OECD forecast), in this case with much greater damage in the emerging and developing world, which is poorer equipped to mitigate the effects in such a scenario.

Table 1. Forecasts of international bodies for real GDP; selection of economies (%)

	IMF (April 2020)	WB (June 2020)	OECD (June 2020)	IMF (June 2020)	OECD (June 2020- “double hit” scenario)
WORLD ECONOMY	-3.0	-5.2	-6.0	-4.9	-7.6
Global trade	-11.0	-13.4	-9.5	-11.9	-11.4
Developed countries	-6.1	-7.0	-7.5	-8.0	-9.3
United States	-5.9	-6.1	-7.3	-8.0	-8.5
Eurozone	-7.5	-9.1	-9.1	-10.2	-11.5
Emerging and developing countries	-1.0	-2.5	-4.6	-3.0	-6.1
China	1.2	1.0	-2.6	1.0	-3.7
India	1.9	-3.2	-3.7	-4.5	-7.2

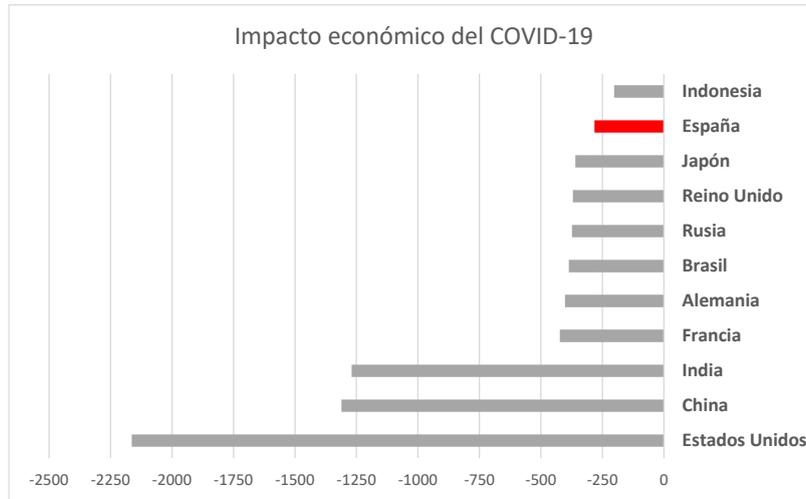
Source: own calculations. Data: International Monetary Fund; World Bank; Organization for Economic Cooperation and Development

When we put an absolute value on the losses in global activity in relation to the provisions at the end of last year, we can put a figure of close to 12 billion dollars<sup>1</sup>, a colossal figure, which would imply that COVID-19 has introduced volatility approximately one year of GDP of the four major economies in the Eurozone (Germany, France, Italy and Spain) together.

Figure 1 shows the specific impact of the crisis on the five major developed economies and five major emerging economies and for Spain, considering the difference from the GDP forecast for these countries for the end of 2020 back in late 2019 and the current forecast. The fall in GDP as a consequence of the pandemic would exceed two trillion euros for the United States, one and a quarter trillion dollars for India and China and around 280 billion dollars for Spain. The recovery to pre-crisis levels, for most developed countries, will take until well into the year 2022, while for much of the emerging world a return to the GDP levels of early 2020 could come this year or in 2021. With regard to low-income developing countries the recovery period will crucially depend on the assistance received (which has been considerable to date, especially in terms of the suspension of foreign debt repayments to public creditors, but still insufficient) and the recovery of raw material exports, itself dependent on the pace of recovery in the major economies.

<sup>1</sup> The IMF estimates of October 2019 and June 2020 are used, as the most recently updated economic forecasts.

Figure 1. Estimate of losses in GDP as a result of COVID-19. Selected economies. Billions US \$ (GDP in purchasing power parity)

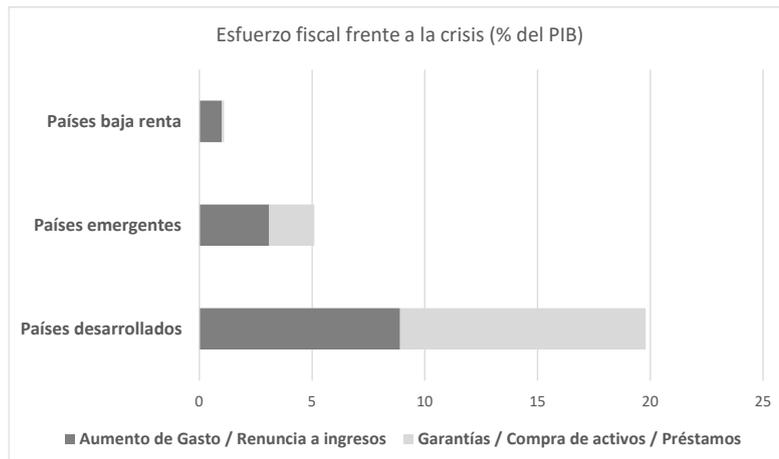


Source: own calculations. Data: International Monetary Fund forecasts.

Note: The results are obtained by applying to the GDP level at the end of 2019 (provisional figures) the difference between the IMF's forecast growth for each economy in October 2019 and the forecast in June 2020. Note that GDP is defined in purchasing power parity.

II. In our last Quarterly Report we pointed out the debate raging since the Great Recession between those in favour of greater fiscal activism to sustain growth and tackle structural changes and others concerned with the accumulation of growing imbalances in public accounts had come to an end, in favour of the former, with the outbreak of the pandemic. There are no precedents for the level of massive public assistance to individuals and companies that has been implemented in recent months, and the support on the part of the different governments for employment and maintaining the flow of bank credit; in other words, the definitive replacement of frozen private spending with public spending. We'll explore in depth the future implications of the indebtedness that comes with that in our Under the Microscope section later but below we offer some perspective of the magnitude and the type of this assistance and the differences, minor in absolute terms, between countries<sup>2</sup>.

Figure 2. Fiscal expansion in response to the crisis (I). Magnitude and nature of expansion (% of GDP)



Source: own calculations. Data: IMF.

Firstly, we must underline the colossal existing difference (see Figure 2) between the economies' capacities to respond according to their degree of development. And clearly, faced with the emergency, these differences in capacity lead to

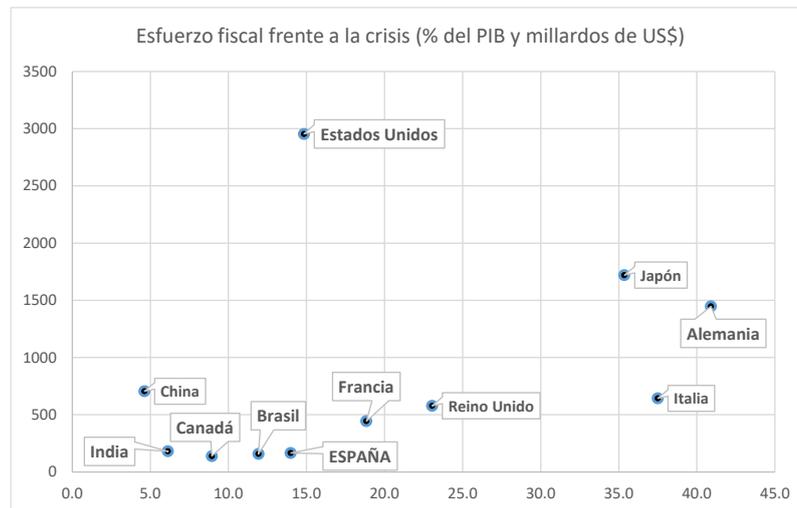
<sup>2</sup> For a breakdown of the actions taken by each country in response to the crisis see this detailed policy tracker compiled by the International Monetary Fund at <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>

very different degrees of support. Even accepting that the crisis, at least for now, has affected developed countries to a greater extent than developing countries, the difference is not 20:1, which is the existing divergence between the fiscal effort of the most and least advanced economies (as a percentage of their respective GDPs; in absolute terms the distance is much greater). Emerging countries have made direct and indirect injections in their economies which also differ from those affected in developed countries (approximately 25% of these).

With regard to the form of assistance, while poorer economies have geared their limited efforts toward increasing public spending and foregoing fiscal revenue (which are not exactly buoyant), emerging countries have also mobilised resources in the form of credit guarantees, preferential loans and asset purchases (debt and/or capital injections in companies in compromised positions). On the contrary, these formulas not directly linked to current spending and taxes have constituted more than half of the assistance provided in developed countries. Note that the second type of measures classified by the International Monetary Fund involves the total or partial recovery of the money injected, being loans, guarantees not requiring activation, or the acquisition of the assets of private companies (debt or shares) that would be divested in the future.

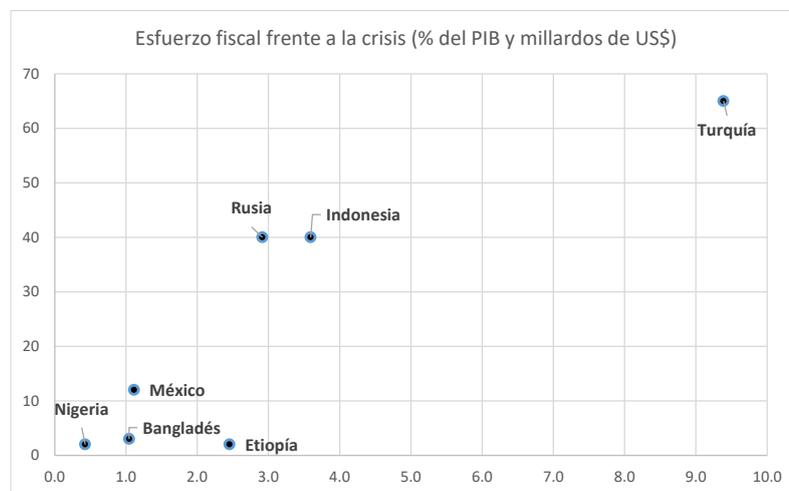
Figures 3 and 4 reveal the enormous disparity in fiscal expansion that is occurring not only among different types of economies but within each group. The first of those graphs offers an image of total fiscal injection to date, both in volume and as a percentage of GDP for a selection of major economies that have exceeded 100 billion dollars in fiscal assistance. Figure 4 shows other major countries, at least in terms of population, where support has remained below this figure.

Figure 3. Fiscal expansion in response to the crisis (II). Selected economies.



Source: own calculations. Data: IMF.

Figure 4. Fiscal expansion in response to the crisis (III). Selected economies.



Source: own calculations. Data: IMF.

There are a number of reflections to make on this information. Certainly, the US fiscal stimulus for a sum of 3 trillion dollars (while they continued to debate in the legislative chambers on proposals that would constitute additional figures, also in the trillions), towers above those made in other countries, even though as a percentage of GDP, Germany leads the way in fiscal effort (for a total equivalent to more than 41% of annual production). Japan, where Government stimulus programmes have been a common prescription (and not a particularly effective one, incidentally) for more than three decades, has acted not only in response to the pandemic, but to compensate the brutal impact on private consumption of the increase in VAT<sup>3</sup> in October 2019, which led to a severe contraction in GDP even before the outbreak of the crisis.

But perhaps most notable about Figure 3 is the ostensible divergence in the intensity of fiscal compensation practices by European countries, which could lead to very different outcomes from the crisis in the economies of the Eurozone in particular. Nevertheless, despite the common claim, this is not a question of a prodigious North against a more austere South. So while Italy trails Germany in fiscal rollout, above 35% of GDP, countries like Denmark, Sweden and Finland (not reflected in the graph) are at around half or even a third of this percentage.

Spain, on the other hand, is showing a degree of restraint (to mid-June, 165 billion dollars, 14% of GDP under any concept) which places it second among the major Western economies (after Canada, a country less affected by the crisis) in the table of least expansive responses to the coronavirus. Given the slogan of the moment (“Please, spend as much as you can, and then, a little bit more”, in the words of IMF Director General, Kristalina Georgieva) it departs in the opposite direction, taking into account the impact on our economy and in comparison to the other extreme of Italy, it is not surprising that many consider this fiscal stimulus to be insufficient. We shouldn’t forget however, that it is probably wise to keep some powder dry to be able to provide additional supports, more specific in terms of groups and sectors particularly affected over the coming quarters.

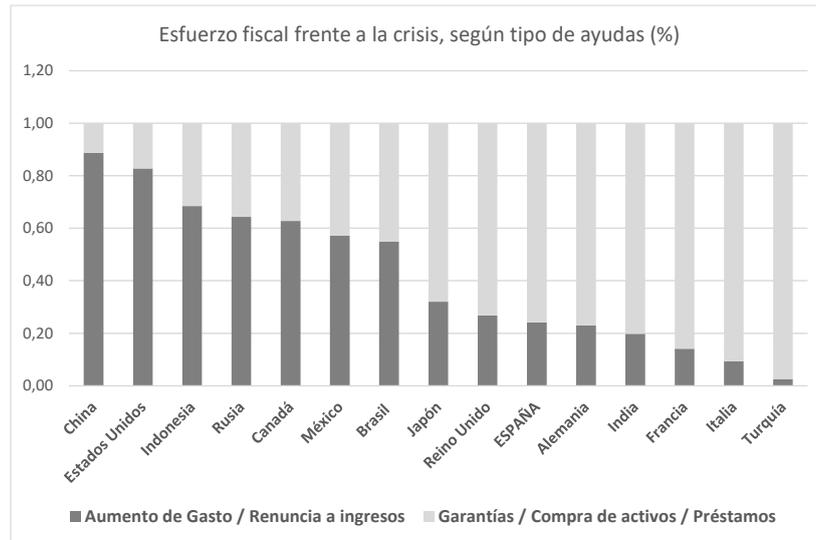
In the emerging world, it is worth noting that, despite having the resources for a greater stimulus package, China has shown considerable moderation, implementing measures for 705 billion dollars, less than 5% of GDP. The imposition of very strict, but geographically limited and (apparently) successful lockdowns that have reduced the impact on demand of the contraction in private consumption (a factor that has been keenly felt in Europe), together with concern for excessive indebtedness at regional and local levels of the Chinese public administration, might explain this restraint. The rest of the emerging world, as has been noted, has shown less extravagance in spending, in large measure due to the greater difficulty in financing it, although in some cases, such as Mexico and Brazil (at federal government level) the same denial of the gravity of the crisis on the part of authorities could be behind the limited fiscal stimulus. Russia, India and, above all, Turkey, are at the other extreme of major developing countries, but nonetheless with fiscal expansion below 10%, if not 5%, of GDP.

For the developing world, the examples included in Figure 4 give testimony to the derisory nature of the fiscal effort that most of these countries have been able to afford.

Finally, Graph 5 reveals the considerable difference between the type of assistance preferred by European countries (together with India and Turkey) and that favoured by the rest of the world. From China and the United States to Brazil or Canada, countries have opted for more direct fiscal stimulus with increases in spending or tax cuts (or deferred payment) as the broadly dominant strategy. In all cases, European countries have defined their programmes in less than 30% of the total on these types of supports and they have opted (in the case of Spain in a proportion of 3:1, similar to the EU average) to guarantee loans, offer loans, assume debt or take equity positions in companies. Although the second type of support offers a greater likelihood of recovering the funds in the medium term (or even not having to actively disburse them), which can provide some relief from the deterioration of the public accounts, it is also likely to result in a weaker stimulus of a rapid recovery. The contrast with the United States is stark, where 83% of supports in these months of crisis have taken the form of greater spending and lower taxes, and the implications for both the pace of the exit from recession and the future fiscal load must be taken into account in future analyses.

<sup>3</sup> Although the rate of VAT in Japan is 10%, very low by European standards, the two 2-point increases in the last three years applied by the Abe Government in an attempt to repair the country's fiscal hole, have been exclusively assumed by Japanese consumers.

Figure 5. Fiscal expansion in response to the crisis (III). Selected economies.



Source: own calculations. Data: IMF.

In this reflection on fiscal actions in response to the pandemic, we must not forget that, beyond the crisis response measures, attention has begun to turn seriously to the medium and long term, and the opportunity offered by the crisis to change the growth model, generally in terms of greater sustainability, adaptation to new technological realities and the labour market and reducing inequality. At least in terms of the debate (we will see to what extent in terms of real implementation), the European Union leads the way in looking beyond 2020.

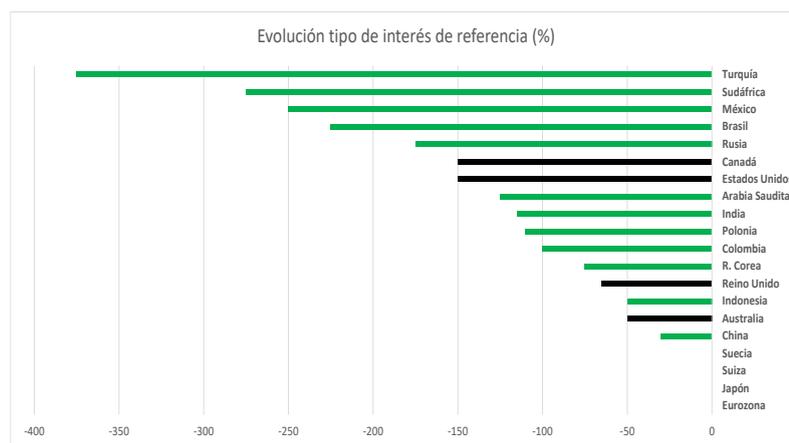
That's why we cannot close this point without mentioning the European Recovery Plan (“EU Next Generation”) designed by the European Commission for a sum of 750 billion euros, to be rolled out over the four-year period 2021-2024. Its objective is to consolidate the economic recovery to transform European economies over the long term. Financing will be a joint effort, with European bonds issued by the Commission itself and repaid with own resources (European taxes) with the guarantee of the 27 EU Member States. The distribution of the overall sum is established at 440 billion in direct investment and 310 billion in loans at reduced rates, distributed based on the degree to which the different Member States have been affected as a result of the coronavirus.

Although the plan is not only timely but necessary, and would significantly reinforce the new community budget of more than a trillion euros corresponding to the Multiannual Financial Framework 2021-2027 (also pending approval) there are three problems in the development of the Plan that must be noted. Before its approval, it is necessary to specify the criteria defining the degree of the pandemic's effect which forms the basis for the distribution of funds, as there appears to be little consensus in this regard. Having overcome this stumbling block, before effective implementation, there must be solid and well-focused projects to finance and the economic spaces most in need of transforming their growth model are not necessarily going to be the most diligent in presenting such projects, if we look at the historical experience. Thirdly, be careful with tax financing. Some of the models mentioned (green taxes, corporation taxes) are exactly the same ones that national governments are talking about. It would be inconvenient to simultaneously establish two levels of additional taxation on the same subjects and assets. The other model mentioned by members of the European Commission, a tax on carbon-intensive imports could lead to retaliation and new trade confrontations, hardly favourable for the world's biggest export power.

III. In relation to monetary policy, we're beginning to run out of adjectives to describe the degree of expansion that has been reached and that continues intensifying.

In the strand of what was traditionally known as conventional monetary policy, as expected, interest rate cuts, where feasible, have been very intense over recent months. As Figure 6 shows, with the margin available for developed countries fully or almost fully exhausted, it has been the Central Banks of emerging countries (shown in green in the graph) that have accentuated these decreases, even in countries where price stability remains a concern, such as Turkey or South Africa. Nevertheless, the exceptional nature of the situation justifies it. With regard to the four Central Banks that have not reduced their reference interest rates in the last six months, note that those rates are already at 0% (Eurozone and Sweden) or in negative territory (Japan and Switzerland).

Figure 6. Reference interest rates of the principal Central Banks. Variation in first half of 2020 (interest rates at end of month, %).



Source: own calculations. Data: Bank for International Settlements (BIS). National Central Banks.

In any case, it has been some time since what was known after the Great Recession as “unconventional monetary policy” (and which, to be honest, must be understood now as entirely conventional) constituted the principal arsenal of the West's monetary authorities. Thus, the principal Central Banks of the developed countries have so far this year acquired around 6 trillion dollars in new assets, public and private, doubling the total volume of purchases in the two years following the onset of the Great Recession.

Given the different outlooks on the monetary actions of the European Central Bank in the countries that make up the Eurozone, the forcefulness of the Pandemic Emergency Purchase Programme is worthy of special mention, extended to mid-2021 and increased to 1.35 trillion euros (to which must be added the 40 billion per month of the asset acquisition programme in place before the pandemic). These sums mean that, in essence, the ECB is in a position to absorb in full the additional public debt created by Eurozone Governments in response to the crisis. Furthermore, the extraordinary injections of liquidity into financial institutions of the Eurosystem have reached 1.3 trillion euros at minimum rates, including part at sub-zero rates. Finally, the large figures concerning the Eurozone must include the release of capital that macroprudential policy has granted to the banks, estimated at some 120 billion euros. Maintaining credit for families and, above all, companies, is a priority, and is considered such by the European authorities, both the Union itself and the Member States.

The situation in the United States is not very different, where the Federal Reserve has expanded its balance sheet by 3 trillion dollars to fund the set of programmes launched (together with a reduction of 150 basis points in the Federal Funds Rate). Within this multiplicity of actions, a sign of the continued process of adding new mechanisms to its arsenal of unconventional policies, the Fed, within its Municipal Liquidity Facility (allocated half a trillion dollars in resources) has begun to issue short-term loans to state and local governments.<sup>4</sup>

Meanwhile, the debate around what instruments can maintain the effectiveness of monetary policy has moved on to explicitly controlling the interest rate yield curve, as conventional measures and the unconventional already used are exhausted, reducing their effectiveness. Certainly the curve is clearly conditioned by asset acquisitions on the part of Central Banks. The question is whether or not to follow the path of the Bank of Japan,<sup>5</sup> that is, explicit control of interest rates from the shortest (commonly through monetary policy) to the longest terms. It is an approach that would in effect probably increase the impact of monetary policy, giving solidity to “forward guidance”, that is, the capacity to influence the expectations of stakeholders. And on the other hand, it would be another source of volatility on financial markets in addition to that generated by the monetary policies applied since the Great Recession<sup>6</sup>.

A final note in relation to monetary policy over recent months: an increasing number of Central Banks in emerging and

<sup>4</sup> As an example of the rates applied, the first loan, for a sum of 1.2 billion dollars was granted to the State of Illinois at an interest rate of 3.82%.

<sup>5</sup> Indeed it is difficult to find any expansionary formula that is not being, or has not already been, used by the Japanese monetary authority, especially under current governor Haruhiko Kuroda.

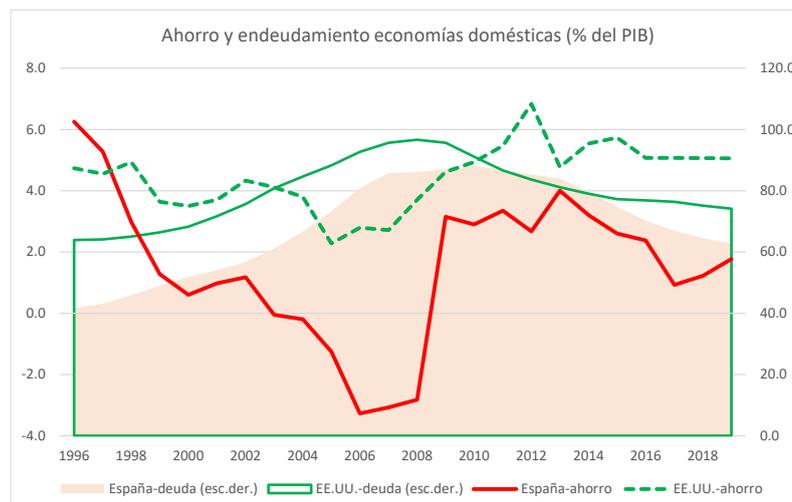
<sup>6</sup> Loyal readers of these Quarterly Reports are aware that our Under the Microscope section will tackle the implications of the ultra-expansionary monetary policy of the last twelve years in a future Report, although the immediacy of the coronavirus has forced us to postpone this hugely important debate for a time in order to focus on other more pressing concerns.

developing countries have shifted towards implementing unconventional actions, particularly in the acquisition of public debt. Poland, the Philippines and Turkey lead the volumes in relation to the size of their respective economies, although always at much more moderate levels than in developed countries. We must not forget that non-developed countries, for reasons of credibility (which can limit their access to markets) and the costs of a potential weakening of their currency (with the resulting increase in the cost of servicing foreign debt issued in dollars or euros), must be more prudent about massive injections of cash into the economy than developed countries.

IV. Not only have the authorities responded to crisis strongly, families have also done so, but in the opposite way. In effect, while the expansion of Governments and Central Banks reaches the unprecedented levels discussed in this Ten-Point Analysis, savings in domestic economies in the west have risen spectacularly: in the United States, for example, the rate of personal savings in relation to disposable economy practically tripled between January and May 2020 (from 8% to 23%). Similarly, the same variable reached an historic maximum in the Eurozone (16.9%), growing by a third in the last quarter.

Logically, what remains to be determined is the fraction of that increase that was involuntary (that is, forced through confinement and the shut-down of activities, particularly leisure activities, by the authorities) and what part was voluntary, as a result of the uncertainty around future income, which has risen exponentially for a considerable part of the population. If it is primarily a case of the former, the restrictive effects on consumption will disappear in the short term and private spending will accompany public spending to accelerate the economic recovery. On the contrary, if this increase in savings is primarily precautionary, private consumption will continue remain limp and we'll see a less dynamic recovery, although also a reduction in debt levels in the domestic economy.

Figure 7. Financial savings and indebtedness in domestic economies in Spain and the United States (% of GDP)



Source: own calculations. Data: Central Bank of Spain; Saint Louis Federal Reserve (FRED II).

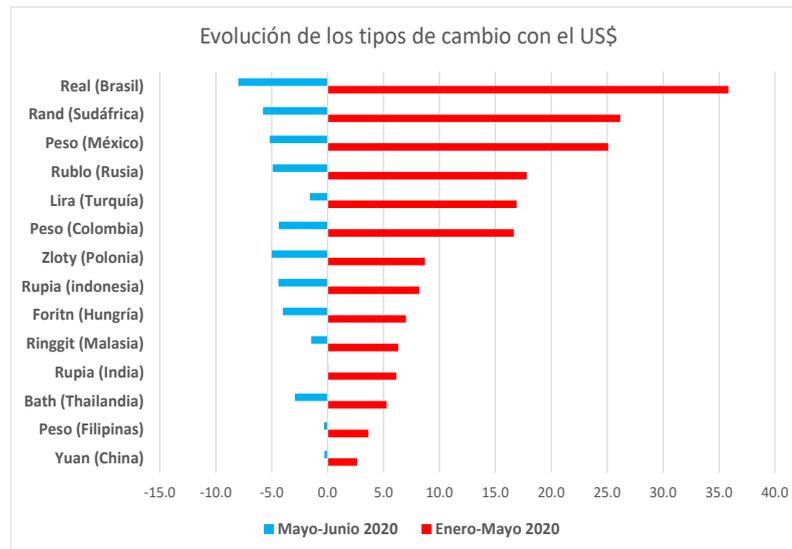
The massive transfer of public funds to the groups most affected by the crisis and most vulnerable in general supports the first scenario, an effort that was much lower after the last recession. These groups of people are more likely to consume. At the same time, and these are real data, it must be underlined that May and June, depending on the country, saw increases in retail sales that systematically reached double digits, pointing to an intense recovery of time lost in term of postponed spending.

On the contrary, the most recent experience after a crisis of such magnitude (the Great Recession) indicated that, faced with such a negative scenario, families ostensibly increase savings and proceed to deleverage themselves. Figure 7 illustrates this situation in Spain and the United States. Note the exponential (and abrupt) jump of savings as a percentage of GDP from 2007-2008, with the outbreak of the financial crisis (since then, starting from uniquely reduced levels; prior to the current crisis levels were not so high) along with the reductions of family debt in the preceding years. Undoubtedly, as stated, the pace of the recovery will be set depending on which of the two forms of saving is predominant.

V. The progressive, albeit clearly partial, normalisation of international economic activity can be perceived in the currencies of emerging and developing economies with respect to the US dollar, as summarised in Figure 8. After a

devastating few months, in which the flight of capital from the non-developed world in search of the traditional safe-haven assets in times of crisis (the dollar, yen, Swiss franc and gold) reached an historic high (100 billion dollars in the first quarter of the year) and caused severe depreciation in many of these currencies, the past weeks have seen a certain correction of the situation, with the position of the dollar weakening against the currencies most affected by such capital flight and, at least, checking somewhat its appreciation against other currencies. Remember that for these emerging and developing countries, and for their companies, dollar debt<sup>7</sup> (and to a much lesser extent euro debt), is still common practice, and the loss in value of their domestic currencies means a higher cost of repaying the debt (the so called “original sin” caused by taking out debt in a foreign currency).

Figure 8. Bilateral exchange rates against the US\$. Selected currencies.  
(% appreciation/depreciation)



Source: own calculations. Data: BIS; FRED II.

Note: Defined as units of national currency for 1 US dollar

The increases in the exchange rate constitute an appreciation of the US dollar against the currency in question, while reductions imply a depreciation of the US\$.

This rebound in exchange rates, the (moderate) return of capital lost and the suspensions of interest payments on debt for public creditors for dozens of low income countries is all good news for the emerging and developing world. But it's not enough. Private creditors are not replicating the relief measures and only consider doing so in negotiations on a country-by-country basis. The funds of international institutions, while useful, have not been extended to the extent required. Economic problems in the West continue to maintain exports well below the normal level, especially raw materials, many of them from these countries. These same difficulties in developed countries imply a significant reduction (estimated at no less than 100 billion dollars for this year) in the remissions that emigrants send to their home countries, this being the primary source of income in the non-OECD world, having surpassed Foreign Direct Investment<sup>8</sup>. And the pandemic is accelerating in quite a few of these countries.

Unless supports are increased in the short term and structural programmes designed that can boost the recovery, debt restructuring arrangements for foreign debt like those already forced through for Argentina, Ecuador, Lebanon and Zambia will be the order of the day. And this will certainly be the least of the problems for the economies affected.

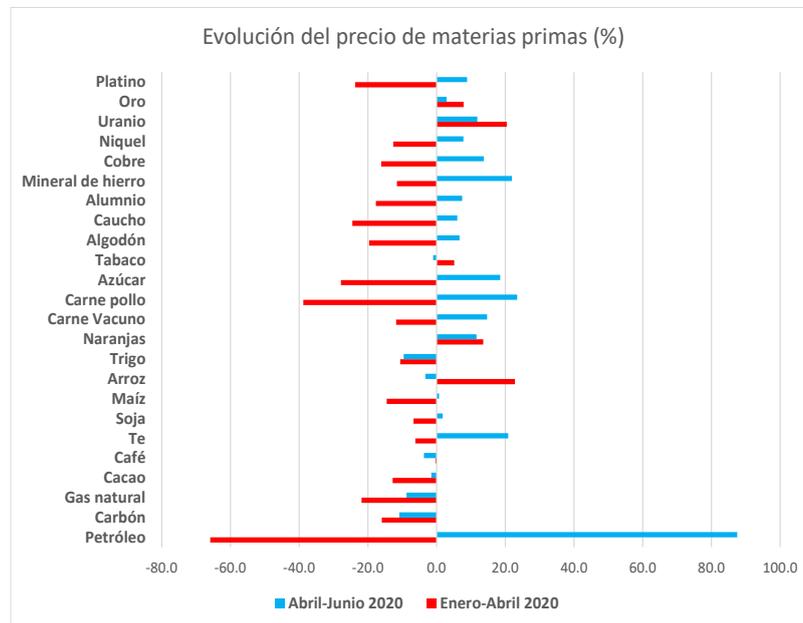
VI. In parallel with the above, the progressive normalisation taking place in raw materials markets and, as indicated for currencies, this process constitutes a significant support for numerous countries outside the OECD that are exporters of raw materials. In fact, in our traffic light analysis of the situation we have significantly improved the valuation (from the most negative status to intermediate in our scale) of the situation in commodities markets. The

<sup>7</sup> Bear in mind that debt in a strong currency is often, for developing countries, the only way of accessing international capital markets. Even where they have the alternative of requesting a loan in their own currency, as is common in emerging countries, taking it in dollars usually means paying lower interest rates and accessing a larger pool of investors. So everything works out better... as long as the dollar (or the euro) doesn't increase in value against the local currency in which the country in question obtains its revenue.

<sup>8</sup> The year 2019 was particularly fruitful in terms of emigrant remissions, reaching an historic record of 554 billion dollars.

reason for this lies precisely in the fact that the recovery of prices (see Figure 9) alleviates the economic hardships of the developing and emerging world, without increasing so much to be an obstacle to the recovery in the West. The developed world, in fact, can afford to tackle higher prices when the recovery from the crisis is consolidated, contributing to the recovery of exporters of raw materials to the rest of the world.

Figure 9. Trajectory of commodity prices (%)



Source: own calculations. Data: World Bank.

The normalisation of the oil market situation, which even encompasses future contracts negotiated at negative prices (buyers were paid for assuming responsibility for stocks) is the biggest news story this quarter. After the volatility generated not only by the global economic crisis but by geopolitical events, described in detail in our last Quarterly Report, prices have recovered over from the collapse between January and April<sup>9</sup> over the last two months (the monthly average for the three reference types of crude – WTI, Brent and Dubai – fell from 60 dollars on average to 20 dollars in April, closing June at around 40 dollars). The agreement between OPEC producers and Russia put a floor on the sinking of prices and the recovery of demand is seeing prices recover to levels more compatible with the needs of producers, but a return to tensions cannot be ruled out as they struggle for market share and limit profitability and with it production of those operators, especially those who extract crude from non-conventional sources, incurring higher costs.

The price for other fossil fuels has continued a much more moderate decrease, for an accumulated trend for the year similar to oil as the first half came to a close. The most widely used form of energy, therefore, remains cheap, which is some support for the global recovery process.

Observe in the aforementioned Figure 9 how the vast majority of commodities that suffered price drops have recovered, particularly in the last two months, as the global economy has been reactivated, particularly in the West. This trend is replicated for all industrial raw materials, both mineral and agricultural materials, from copper to platinum and cotton to rubber.

Some raw materials have had a “good crisis”. Expectedly, in the case of gold, a safe-haven asset (although the logic of that could be argued), with prices increasing 17% in this half from the close of 2019, always in reference to monthly averages. Uranium, a strategic mineral, rose in price by close to a third. Less expectedly, oranges saw strong growth, of up to 25% this half, perhaps as a source of Vitamin C (considered by some to be a factor that combats the virus) or perhaps due to the difficulties in the normal supply processes.<sup>10</sup>

<sup>9</sup> Take into account that the variations in Figure 9 are percentages, so they depend on the base price of the month for comparison. For this reason, the increase in prices in the last two months exceeds the fall in the previous four months, but that is a result of this base effect. In dollars per barrel, as stated in the text, the recovery has made up at least half of the fall.

<sup>10</sup> The World Bank uses the price of the navelina variety of Mediterranean exporters as the reference for this raw material.

VII. Although not many countries or leaders have weathered the storm well (Germany and Angela Merkel being the most obvious exception), we want to highlight here how the world's two largest economies are experiencing particularly tough crises, which have affected the performance of their respective presidents, Donald Trump and Xi Jinping. We refer here not only to the direct confrontation, where bombastic posturing makes a lot of noise, but the deeply concerning protectionist measures, which have seen the opening of a new front recently, this time financial. The United States' principal pension fund (the Federal Retirement Thrift Investment Board) decided to hold an investment in a fund that includes Chinese companies.

As for China, the country let the rest of the world down with its obfuscation in the initial handling of the crisis, and is losing credibility daily with its continued threats (Taiwan), baseless economic sanctions (Australia) or the apparent lack of will to reach agreements to balance the conditions for companies (European Union) that cheerlead the action of their Government. The new Hong Kong Security Law is another step in the direction of breaking any hint of moderation, while the recent border conflict with India adds another focus of tension to the many it already has with many neighbours in South-East Asia (plus Japan) due to the aggressive nationalism that has characterised the country since consolidation under the power of Xi Jinping. If we add to those the well documented structural problems pending resolution (demographic, environmental, indebtedness and major internal inequalities) and the economic cost for China of the inevitable redefinition of Global Supply Chains (see our previous Economic Environment Report), it has not been a positive half year for China. The suppression of a numerical objective for economic growth at the latest Congress of the Chinese Communist Party when faced with the impossibility of reaching the crucial objective of doubling GDP between 2010 and 2020 is merely an anecdote. Achieving this moderately prosperous society (*Xiaokang Shui*), with a broad middle class and poverty eradicated, so coveted by the CCP leaders, seems more difficult under these circumstances.

As for the United States, the consternation and inconsistency, if not out and out folly, that has driven the response to the pandemic, as well as the human and economic costs involved, have damaged the credibility of many of the country's authorities, starting with the President (it is debatable of course, what percentage of citizens, within the country and beyond would afford him any credibility even before the current crisis) and even including the reputed Centre for Disease Control and Prevention in Atlanta. The handling, perhaps even more unfortunate, of the racial problem, only partially visible before, has exploded recently with the "Black Lives Matter" movement revealing an extremely divided country, a situation that's not going to improve over the coming months as we look to the presidential and legislative elections of 3 November. It can't be ruled out that, during this period, an increasingly unstable Donald Trump, could adopt measures that further complicate the domestic and international situation, including a new raft of protectionist measures.

Ultimately, the problems, internal and external, of the two great global powers bring a geopolitical instability that will constitute an additional undesirable obstacle to recovery. And of course, the complications are not limited to these two countries, which is why our Traffic Light Analysis shows a negative status for the global geopolitical situation and a worsening trend.

VIII. One sector that does seem to be having a surprisingly good crisis is the financial markets, particularly in the United States. Their disconnection from the real economy, which measures its losses in trillions of dollars, is glaring. The stock markets have recovered most of the losses of the month of March; companies are taking advantage of extremely low long-term interest rates to replace short-term commercial paper with long-term issues, which have basically doubled compared to a normal year for companies with good credit standing and have increased 25% for those in the speculative section of the credit scale. What's more, some of these companies with low ratings (including several in bankruptcy proceedings like Hertz and JC Penny) have experienced notable volumes of share purchases in recent weeks. The old dilemma would appear to apply here: whether the markets are anticipating a much more energetic recovery than that envisaged by economists and authorities, with growth (and profits) reaching the levels of the markets, or if it will be the markets that will fall back to earth when the reality of a progressive and complicated recovery becomes apparent.

But in reality the response lies in the fact that probably for some time (because the repeated highs in more than a few markets prior to the coronavirus crisis would appear to have little to do with a languid and over-leveraged economic expansion), financial markets have responded less to what is happening or what is forecast to happen in the non-financial economy and more to the unlimited injection of money on the part of Central Banks.

The negative evidence of the performance of monetary authorities that formed part of, or depended on, governments decades back, justified the granting of independence to Central Banks. The subsequent results (much greater price stability in with no costs in terms of growth, in fact the opposite) backed up this decision. Today, we must again

question whether Central Banks are really independent of political power, especially in light of the pandemic. The repeated declarations of Donald Trump, at least on occasion, do seem to have been met with a favourable response from the Fed. There was declaration of the revered Bank of England indicating that it would openly finance British public debt. There was interference of the German Constitutional Court requiring explanations from the European Central Bank on its asset purchasing policy and the control of the public debt rate curve exerted by the Bank of Japan, which provides free long-term financing to the government. There are grounds to suspect a certain loss of independence and this will be something we'll return to in our Under the Microscope section after this Ten-Point Analysis.

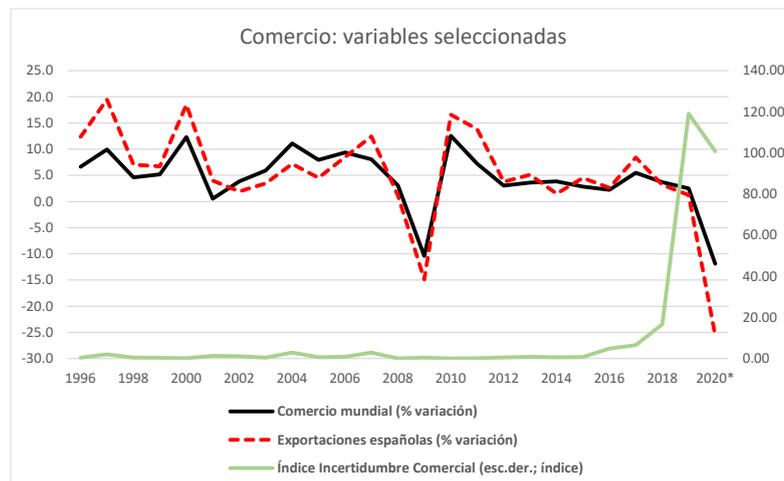
But Central Bank theorists have always highlighted that, alongside this independence from political power, Central Banks should also be independent from financial markets. And the truth is, ever since “Greenspan’s put” two decades ago (basically an exercise in asymmetrical monetary policy whereby markets rise freely but are quickly bailed out by the Federal Reserve in the event of problems), some observers, including the author of this Report, note with some concern what appears to be excessive willingness among certain Central Banks, with the Federal Reserve again at the head, to prevent significant losses in financial markets, even where the economic situation would justify it. Until the bubble inflates to such dimensions (the Great Recession) that nobody can keep it from bursting.

Perhaps it should come as no surprise that markets are disconnected from the real economy, because what determines their behaviour is the connection with a permanent expansionary monetary policy. Nor should it come as a surprise, however, were this situation to end really badly again.

IX. Unlike the financial markets, global trade has been particularly badly hit by the crisis, which is to be expected, given the greater dynamism of exchanges with respect to production in both the peaks and troughs of the cycle. Figure 10 shows that, affected by the succession of supply shocks of the past quarter, and in a scenario of unprecedented protectionist tensions over recent decades, global trade will contract in 2020 by a record figure (see also Table 1 at the start of this Ten-Point Analysis) for the last quarter century (in reality it will be the biggest drop in trade activity since the Second World War).

This drop will be singularly intense for developed countries, particularly European countries many of which are export powers with their preferred trading partners Member States of the EU, the economic space that will be hardest hit by the fall in activity in 2020. To illustrate this effect, Figure 10 shows a simple exercise developed by the author to estimate the performance of Spanish exports and which anticipates a fall of 25.6% compared to the 2019 figures.

Figure 10. Performance of some selected commercial variables



Source: own calculations. Data: World Uncertainty Index; IMF.

Note: the estimate for the performance of Spanish exports in 2020 was conducted by the author based on the latest IMF growth forecasts for the 20 biggest destinations for these exports, the weight of same in the total of Spanish overseas sales and the elasticity of our exports to these markets with regard to their respective pace of economic growth.

Nevertheless, in the second half of the year, albeit progressively and in line with economic activity in general, trade should bounce back, which will be particularly important for an economy like Spain's that demonstrated in the last recession how it has an export sector it can rely on as a crucial pillar of recovery. It is critically important, therefore, for Spain and for the other countries, that credit financing, so important for international trade, does not fail, due to perceived greater risk on the part of banks, leading them to more stringent, or direct cuts to, financing. As already

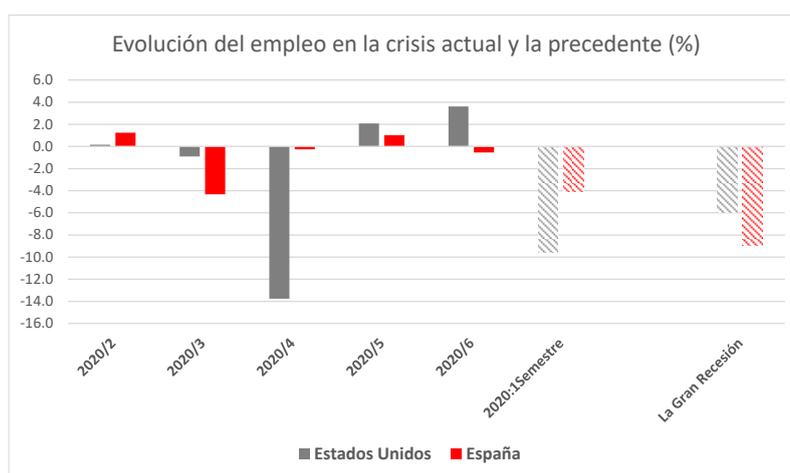
indicated in the last report, public guarantees of this type of credit must be particularly generous.

X. We will use this final point of our Ten-Point Analysis to relate here a number of anecdotes, more meaningful if understood as such than for their economic repercussion. Nevertheless, the first of them does reveal, in the case of Spain, considerable transformation in the labour market and it could be quite significant if it marks the start of a permanent change.

The first of these aspects, which could disconcert the occasional observers, is the radically different performance of employment and unemployment figures in the United States and in the European Union during this crisis. So, while in the European case, unemployment, measured officially, has risen barely three tenths of a point, in the United States unemployment quadrupled from 3.5% in February to 14.7% in April. How is this possible? Simply due to the form of calculating the temporary protection schemes (the “kurzarbeit” scheme in Germany, “furlough schemes” in the UK and Spain’s “ERTEs”), Europe maintains these workers as employed in statistics. In the United States, they are included in the calculation of unemployment numbers. Additionally, and even though North American standards for this type of coverage is new and has been widely used, the numbers of jobs that enjoy this public protection does not get close to the 45 million in the EU at the height of the crisis. If all of these were calculated as unemployed, the European rate would shoot to 30% of the active population.

What's most interesting in the Spanish case is that the Temporary Suspension of Employment scheme or ERTE constitutes, at least circumstantially, a rupture with the long, nefarious history of external adjustment of the labour market. In other words, traditionally, working hours and salaries are not adjusted but rather, large numbers of temporary workers in the Spanish labour market (a record in the West) are laid off on a massive scale, with those on permanent contracts much more protected, in a labour segmentation that is a cancer in our economy. With the ERTE, the volume of layoffs has been much lower, in a sacrifice shared with the companies, temporary and permanent workers and public funds (although these would have suffered more in the event of the layoff of most of the 4 million people that are covered by this scheme). The left hand side of Figure 11 shows the difference, which we repeat has more to do with the calculation than the reality, between the performance of employment in the United States and in Spain, with a much greater reduction in the former, although the rate of recovery appears much more intense. But the most significant element is observed on the right hand side of the graph: while during the two central years of the Great Recession, the segmented Spanish labour market's employment figures fell by no less than 50% more than the absolutely flexible US market. In the first half of this year, 60% fewer jobs have been destroyed, thanks to the application in Spain of these schemes more common in central European countries, especially Germany.

Figure 11. Employment in Spain and the United States during the current crisis and the Great Recession (%)



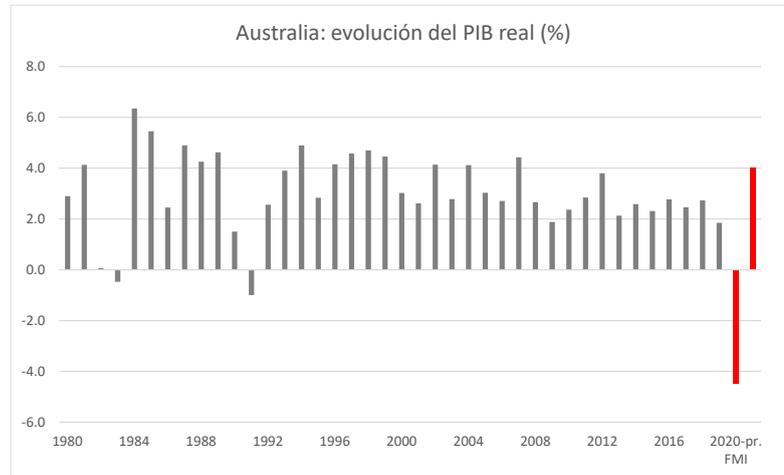
Source: own calculations. Data: Central Bank of Spain; FRED II.

A final commentary on these temporary employment protection schemes. The adjective “temporary” is very important: although the decision to extend these schemes not only for the rest of 2020 but even into 2021, anticipated in Spain and already taken in France and Germany, among other countries, is reasonable, it must be borne in mind that it is not even remotely possible to save all the jobs affected by the crisis. The protection schemes should only be extended on a selective basis, and for those jobs that correspond to activities that are likely to have a consistent recovery. Allocating public money to subsidising jobs with no future on a continued basis would be a senseless waste, and an obstacle to the

sectoral reordering of a healthy, dynamic economy.

It must also be briefly noted that after 29 years of uninterrupted growth, COVID-19 has achieved what seemed impossible: Australia is going to suffer its first recession since 1991 (see Figure 12). Even still, there will be much less activity than in most of the rest of the West.

Figure 12. Growth of real GDP in Australia (annual variation; %)



Source: own calculations. Data: IMF

The last note in our Ten-Point Analysis is to note the classic forcefulness of the response of US authorities to severe economic crises, beyond the general philosophy on how to manage the economy<sup>11</sup>: the package of supports provided, by local and state governments and, above all, the Federal Government, mean that more than half (some studies suggest up to 70%) of the US citizens in receipt of support have received more money through the schemes than they would have obtained working. It's great for tackling a crisis, but not so great in terms of incentives...

<sup>11</sup> Aside from this forceful presence of the public intervention when the situation requires it, despite opposition to it most of the time on the part of many citizens, politicians and interest groups, other classic myths of the US economy, such as the love of commercial liberalism or the intensity of competition in its markets, have also been cracking for some time, and with good reason.

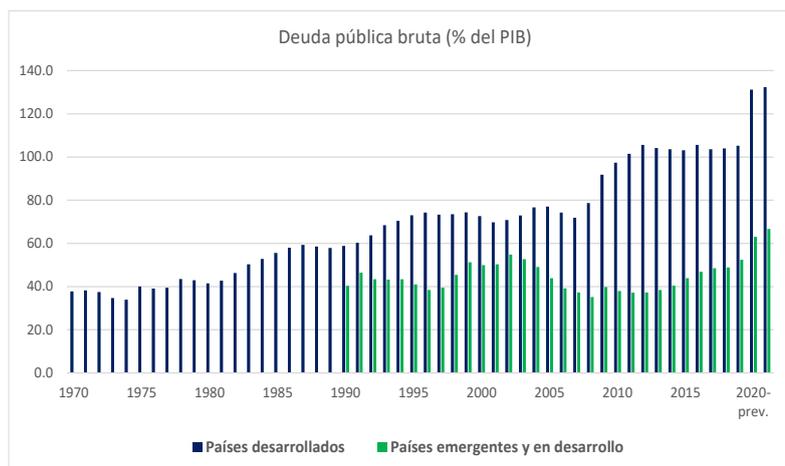
## Under the Microscope

### *What to do with public debt?*

#### ***The current situation and the immediate future***

The trend in the growth of public debt (private debt has also ostensibly increased, an aspect we won't address in this analysis) over recent decades is a cause for concern, although one might suggest that it has been countercyclical. In other words, when different economic crises have occurred, Governments have tackled these recessions through both the automatic stabilisers of the cycle (mainly unemployment insurance and progressive taxes) and ad hoc decisions, leading to an increase in public debt levels as a proportion of GDP. This trend has become a cause of debate and dissent between experts and authorities. Unfortunately, during expansionary phases (which, by the way, are considerably longer than recessions) interest in the issue has dissipated, and the effort in most countries to return to previous levels of debt has been minimal, with result that the debt/GDP ratio has stabilised. This is the story that Figure I<sup>12</sup> shows us for developed economies: strong increases in the ratio in times of crisis, especially after the Great Recession of 2008, and stability in times of expansion. As the graph shows, the increase of the ratio as a consequence of COVID-19 and the response has brought the public debt of developed countries above 130% of GDP.

Figure I. Gross overall public debt (% of GDP)



Source: own calculations. Data: IMF

Aside from the similarity of forecasts for the immediate future (another record level of public debt/GDP, which will exceed 65% in 2021), the data available (in a shorter period) for the emerging and developing world, tells us, in aggregate terms, a somewhat different story. In this case, increases in debt in difficult times (less than in developed countries) have followed a markedly downward trend in boom times. That does not mean that past decades have not seen numerous individual episodes of public debt payment problems in the non-OECD world, especially foreign debt in strong currencies, primarily the US dollar. Nor does this imply that macroeconomic management of these countries has been better than in the West. In reality, in many cases they have not taken in more debt simply because they have been unable to find financing. When international markets have allowed it, too many non-OECD governments have indeed taken in too much debt too quickly.

Therefore, with a starting point that is far from ideal (remember, before the pandemic and after a decade of

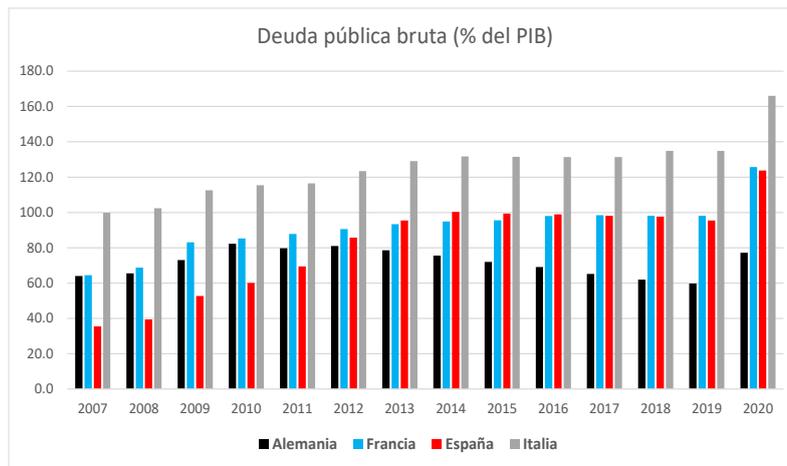
<sup>12</sup> Throughout this analysis we have used the data for overall public debt of countries in gross terms. While net debt offers lower values, providing comfort for some, the growing trend in the debt/GDP ratio is the same. Moreover, the assets subtracted from gross debt to offer net debt are not necessarily realizable when increased spending is required or their disposal might allow for a favourable adjustment in the short term but complicated financing of the country's commitments in the future.

economic expansion, the public debt/GDP ratio in the West was over 100%) and the current fiscal effort (see point 2 of our Ten-Point Analysis in this Report), States’ debt levels must be a cause for some concern, with a view towards tackling the problem not immediately but certainly when the current crisis is behind us. However, there are few voices calling for this. Most seem relatively comfortable with these unprecedented figures for peacetime.

Below, we’ll review the criteria for making debt sustainable, as excess debt has been historically corrected and because there appears to be a certain relaxation of public debt levels, which only a decade ago would have been considered little sort of suicidal for the economies affected.

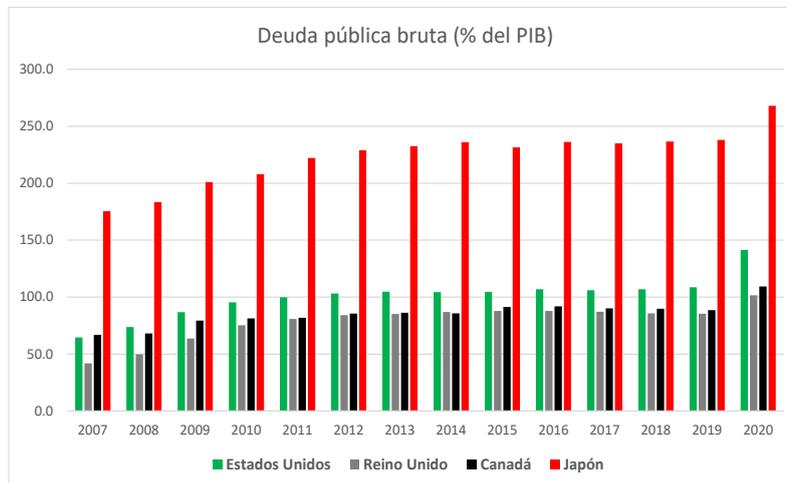
Figures II-V reflect the evolution of the debt-to-GDP ratio for a group of economies. We’ll reflect on the differences between them and the potential in terms of sustainability. We have selected the four major Eurozone economies (Germany, France, Italy and Spain), the other four G-7 countries (United States, Japan, United Kingdom and Canada) and seven emerging economies, in search of geographical diversity, based on per capita income, growth rate and the degree of access to the markets (China, India, South Korea, Russia, Poland, South Africa and Brazil).

Figure II. Gross overall public debt, Selected economies(I) (% of GDP)



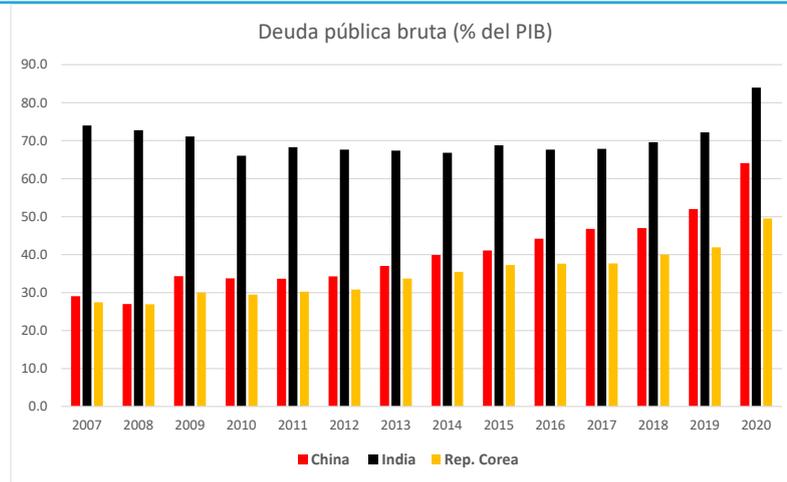
Source: own calculations. Data: IMF

Figure III. Evolution of gross public debt, Selected economies (II)% of GDP



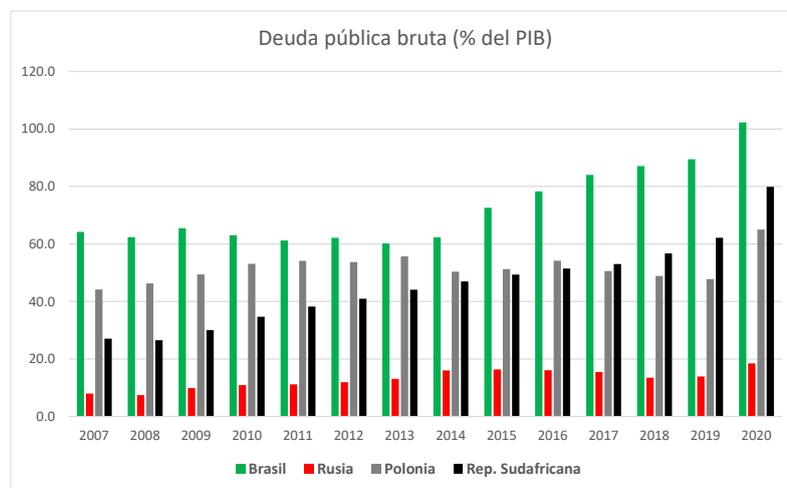
Source: own calculations. Data: IMF

Figure IV. Evolution of gross public debt, Selected economies (III) (% of GDP)



Source: own calculations. Data: IMF

Figure V. Evolution of gross overall public debt, Selected economies (IV) (% of GDP)



Source: own calculations. Data: IMF

### The sustainability of debt

What can we say about the capacity of States to continue to meet their obligations to creditors? Is the debt sustainable? Can the State meet interest payments and repay the principal when required and on time? In the Annex to this section, there is a brief technical summary of the economic relations that guarantee the debt reduction process and, with that, its sustainability. Suffice to say here that the confluence of two factors leads to this favourable scenario: first, the existence of a primary budget surplus, that is, excluding interest payments (ignoring the burden of the past), the State earns more than it spends in the period in question. Secondly, that nominal economic growth exceeds the average nominal interest rate paid on the debt. That means that the generation of wealth in the country in the same period, combined with inflation (/reducing the value of the inheritance from the past, in this case in the form of a burden, the debt) exceeds the cost of debt to the economy, including the compensation that creditors received for inflation forecast (one of the factors that determines the interest rate paid to debt holders), in compensation for the loss in value of the money invested.

If none of the two conditions are fulfilled, the exponential trend in debt will eventually become unsustainable, albeit not in the short term. This will depend on a number of factors, from the starting debt level to the credibility of capital markets. If one of the conditions indicated is fulfilled but not the other, a simple calculation (see Annex) can determine the trend, upward or downward, for debt.

Turning to the global outlook, with regard to the primary balance, despite long growth even before the coronavirus, 60% of countries, employing the 2017-2019 average, were already in a primary deficit situation. In other words, they couldn't cover their annual spending with revenue even discounting the interest payments on doubt. It is true that the data were more favourable for developed countries, with 25 of the 37 for which the IMF publish data showing a

primary balance surplus.

With regard to the second condition, readers of these Quarterly Reports will know that economic growth after the Great Depression was not particularly dynamic in most of the world and languished further in 2019. Meanwhile, in the West not only has inflation stayed under control, but the Central Banks have had severe difficulties (and on more than a few occasions have failed to achieve it in the last decade) getting it to around 2% which is in and around the target<sup>13</sup>. In other words, nominal growth has been very robust, extensive national differences notwithstanding, making it difficult to fulfil this second condition.

Combining these two elements (relatively inflexible primary fiscal positions that will clearly deteriorate as a result of COVID-19 and limited growth), it appears to be a clearly negative trend for sustainability. But there is a third element that explains the aforementioned relatively relaxed view of accumulated public debt levels: public debt interest rates have been moving downwards structurally since the 1990s, a trend accentuated after the Great Recession.

In effect, at least since the Second World War, it has never been so cheap for States to borrow as it is now (and also has a considerable impact on private debt), particularly for the long and very long term and for western countries in particular. In some cases, we have even seen negative costs for issues over ten and up to thirty years. So how can a State not become indebted then, and continue to do so? Should we even expect a reversal of this downward trend? We'll return to that presently, but we must underline that, even though financing conditions have not even approached such a privileged arrangement for the non-OECD world, the average cost of debt has also fallen this century; dozens of countries previously all but excluded from the market have not had regular access to them. That said, the sort of turbulence that reverses this downward trend in interest rates, is also more common than in the West, where the only really significant case is the case of the Eurozone periphery from 2010 to 2012.

### ***Some national examples***

In Table I we look at the fifteen economies for which we have presented above the recent trends and short-term forecasts for public debt, and offer some data for assessing the position from which to tackle the exceptional fiscal effort forced by the response to the pandemic.

Bear in mind that this is NOT a formal exercise in sustainability, which would require the use of forecasts for activity and price variables for the years to come (rather than the average of recent years, which is what is presented here) and an average cost weighted for the different total live debt issues (rather than the rate of ten-year bonds, the traditional benchmark for public debt, which is used here). The aim is to show to what point the sustainability of the debt is dependent upon maintaining interest rates that, at least until recently, were considered exceptionally low.

The first column of the table shows average nominal growth for the last three years in each economy (alongside that, the decomposition, first the real growth figure and then inflation) to meet with the interest rate paid for debt (same period) which appears in the second column. Below we present the primary balance and the average for the period 2017-2019. In an ideal situation the value of the first column would be higher than the value in the second and the value in the third column would be positive. These figures are followed by the IMF's debt forecast for the current year<sup>14</sup> and, finally, the interest payments. Naturally, these final three columns are presented as a percentage of GDP for the economy in question.

Table I. Variables relating to debt sustainability; selection of developed and emerging economies.

<i>COUNTRY</i>	<i>Nominal GDP growth (real + inflation) (average 2017-2019)</i>	<i>Interest rate for 10-year bonds (average 2017-2019)</i>	<i>Primary budget balance (% of GDP) (average 2017-2019)</i>	<i>Forecast gross public debt 2020 (% of GDP)</i>	<i>Interest payments on debt (% of GDP) (average 2017-2019)</i>
<b>Spain</b>	<b>3.6 (2.9+0.7)</b>	<b>1.4</b>	<b>-1.1</b>	<b>123.8</b>	<b>2.4</b>
Germany	2.9 (1.7+1.2)	0.2	2.1	77.2	0.8
France	2.5 (1.5+1.0)	0.6	-1.5	125.7	1.7

<sup>13</sup> The fact that inflation has been so low in most of the West has made repaying debt more expensive (if high inflation erodes the value to the debt, damaging the creditors, deflation or minimal growth in prices has the opposite effect). This is one of the most oft repeated arguments by those economists who defend the need to force a period of inflation above the targets of the Central Banks, for the purpose of balancing the last few years of not reaching those targets.

<sup>14</sup> Estimated by the author in the case of Poland, in the absence of updated IMF data.

Italy	1.6 (0.9+0.7)	2.0	1.3	166.1	3.7
United Kingdom	3.3 (1.7+1.6)	1.3	-0.8	101.6	1.5
United States	4.0 (2.4+1.6)	2.3	-2.7	141.4	2.0
Canada	3.3 (1.1+0.6)	1.7	0.1	109.3	0.4
Japan	1.7 (1.1+0.6)	0.1	-2.9	268.0	0.4
China	8.5 (6.6+1.9)	3.3	-3.4	64.1	0.9
India	11.2 (7.3+3.9)	7.4	-2.3	84.0	4.7
South Korea	3.8 (2.7+1.1)	2.1	0.6	49.5	0.9
Poland	5.1 (4.2+0.9)	2.9	-0.1	65.0	1.7
Russia	7.4 (0.6+6.8)	9.1	-0.5	18.5	0.4
Brazil	5.0 (-0.8+5.7)	11.1	-1.9	102.3	6.4
South Africa	5.9 (0.9+5.0)	8.6	-1.2	79.9	3.5

Source: own calculations. Data: International Monetary Fund; BIS; National Central Banks

Starting with the primary balance, even in the final phase of expansion 11 of the 15 economies presented a deficit. The deterioration forecast for 2020 will break historic records, taking several of the selected countries to double digit primary deficits. The recovery of fiscal balance, not to mention the recovery of the economies themselves, will be slow. Apart from the case of Germany, the first condition of sustainability (primary surplus) can be ruled out until at least the second half of the decade.

With regard to nominal growth, among the countries selected, only the United States reaches 4%, relying more on real growth than prices, a combination that could be assumed to be relatively satisfactory. Although 2020 will offer incomparably poor figures, while the recovery forecast for 2021 will move the figure in the opposite direction, if the medium term implies a return to values similar to those shown in the Table, nominal growth will not be a solid shock absorber for debt with which the West will be saddled when exiting the crisis. Despite this, note that, except in the case of Italy, the first column figure is higher than the second in many cases, including Spain and by some distance. That implies that the second condition will indeed be met, and that is because the interest rates on debt, as already discussed, are exceptionally low, which leads to a more modest annual cost in terms of GDP (see the final column in the Table). It is particularly noticeable in the case of Japan, with scant nominal growth and despite a level of debt that more than doubles GDP growth, it only dedicates four tenths of annual production to interest payments. Therefore, even though debt levels upon exiting the crisis in the West will be alarming, it does appear that sustainability will be possible (with the likely exception of Italy it does not notably transform its economic dynamism) thanks to the interest rates at which this debt is financed.

The situation differs much more among the emerging countries selected. While Poland can more or less be thrown in with the outlook for most of the developed economies, with the advantage of more intense real growth, the situation in the major emerging Asian economies is quite favourable. Despite the high debt levels common to undeveloped economies, and primary deficits, robust nominal growth in China and India should mean they can afford to keep debt under control. The situation is even better for South Korea, with the healthiest fiscal data of the 15 economies selected, although its growth rates correspond more to those of a developed economy (which we can consider it without much of a stretch) than an emerging one<sup>15</sup>.

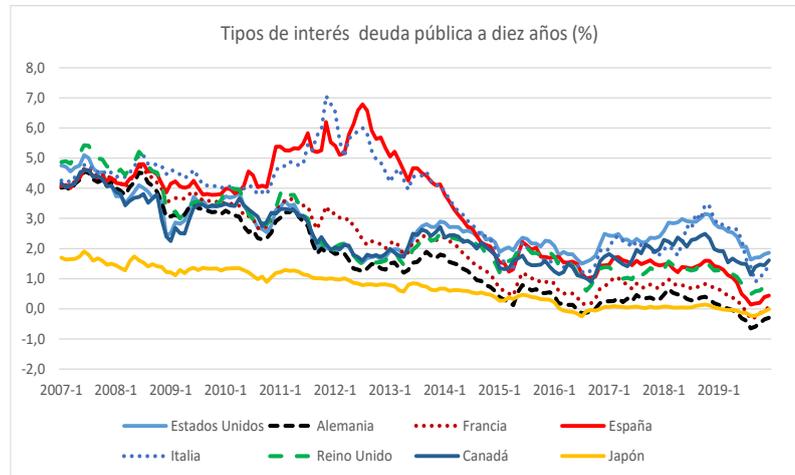
On the contrary, expectations are far from flattering for Brazil and South Africa in the absence of meaningful structural changes that drastically modify the scenario. These two were in primary deficit even before the pandemic; their debt levels are clearly excessive for their stage of development and the credibility in markets of both countries (despite the efforts of the two Central Banks to maintain it); and even though nominal growth is high, it is due solely to excessive inflation, which translates into more onerous interest rates. That all means that neither of the two sustainability conditions are met, leading to a very worrying scenario in the medium term. While the case of Russia is similar in terms of growth, inflation and rates, the Putin Administration has made maintaining reduced levels of public debt one of its macroeconomic policy priorities (very reduced we can even say, as the Table shows). With its Sovereign Wealth Fund, with hundreds of billions of dollars from oil exports, we can remove any doubts about the sustainability of Russia's public debt.

<sup>15</sup> Remember that South Korea and Poland are both members of the OECD, but so are Mexico and Turkey, economies that couldn't under any circumstances be considered developed. In fact, the OECD is a club that is home to quite a high number of emerging economies.

**Why such low interest rates?**

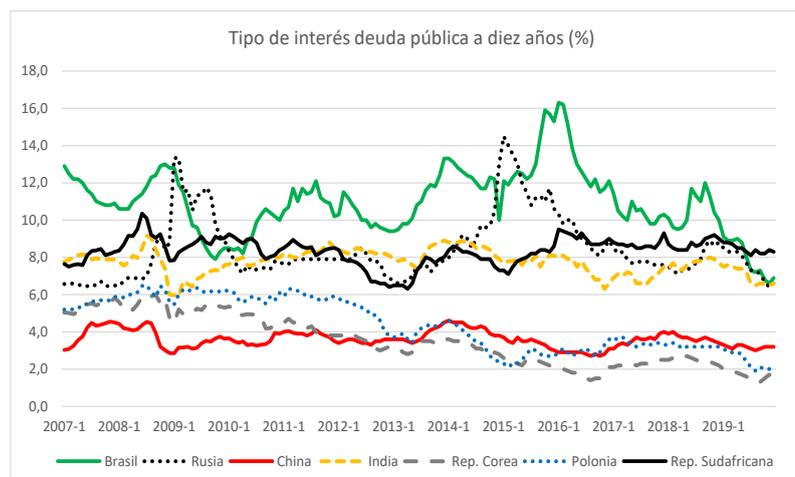
Figure VI reflects the downward trends, to levels close to, at or even below zero (see Germany and Japan at the end of the period), in interest rates for the principal public debt bonds (ten years) for the developed economies.

Figure VI. Interest rates for 10-year public debt. Selection of developed economies (%)



Source: own calculations. Data: National Central Banks, National Statistics Institutes

Figure VI. Interest rates for 10-year public debt. Selection of emerging economies (%)



Source: own calculations. Data: National Central Banks, National Statistics Institutes

Figure VII reveals a similar trend, although less acute and far from the practically null rates seen in Europe and Japan for emerging countries with adequate macroeconomic management, especially in terms of inflation control. Those who do not comply have to contend with ostensibly higher rates.

But why these reduced interest rates, especially in the West, even over the long term? The reason that immediately comes to mind is: Central Banks - unconventional monetary policy - massive purchase of public debt on secondary markets - rising debt prices - falling interest rates.

Well yes, but that's not all. Firstly the downward trend in interest rates, as has been indicated, is born not of the Great Recession but dates back to the 1990s. Without exaggerating<sup>16</sup>, this trend has been influenced by: the reduction and stabilisation of inflation rates, global savings and investment rate trends, which have followed divergent courses due to multiple factors (upwards and downwards respectively) and the development of financial markets, with increased hedging opportunities.

Focussing on the accentuation of rate reductions for increasingly longer terms in recent years, it is clear that the

<sup>16</sup> In truth, it would require another Under the Microscope of its own, and perhaps we'll publish one in the future.

expansion of Central Bank balances, with the acquisition of billions of dollars of public debt (euros, yen, etc.) has a lot to do with that. Furthermore, the intensification of these measures in response to the current crisis, let alone if the policy (maintained by the Central Bank of Japan) of exercising direct control of the interest rate curve spreads, would mean maintaining interest rates close to the current levels. Let's not forget, however, that private investors have also reinforced medium, long and very long-term rates, with growing demand for public bonds, especially from those considered safe countries, for the following reasons:

- The increase in demand from institutional investors (pension funds, insurance companies), which reflects an increase in desire for these assets on the part of an ageing population.
- The increase in demand from the banking system for safe assets to comply with new capital and liquidity requirements in the wake of the Great Recession.
- The increase in global uncertainty increases general demand among the population for assets that are safe over the long term.

It would appear, therefore that low interest rates are here to stay, at least for a period and as long as economic growth isn't reactivated on a structural basis and while Central Banks consider the benefits of these interest rate levels to be greater than the risks involved.

### ***But how have excessive levels of public debt been reduced over the course of History?<sup>17</sup>***

At least six mechanisms have been historically been used, to a greater or lesser extent, varying degrees of success, by Governments to reduce excessive levels of debt. We'll refer to them briefly below, assessing their suitability for the current situation.

- *Acceleration of economic growth*: greater growth directly improves the relationship between the creation of nominal wealth and interest rates paid for debt and, indirectly, increasing revenue and reducing spending, the primary budget balance.
  - Is it widely used? Key in the most successful debt reduction processes. It is not a quick process and usually requires structural reforms.
  - Assessment: Optimal, undoubtedly.
  - Is it a feasible mechanism today? The entire world commits to it, but if growth was not already solid before the pandemic it was for reasons that remain. Unlikely without significant reforms. The strictest advocates of the idea of "secular stagnation" would see it as particularly difficult. Logically, with reforms and the right macroeconomic policies, the margin is greater in emerging and developing countries.
- *Fiscal consolidation*: through spending reductions and/or increased taxes, the primary budget is improved directly, and, indirectly, so is the interest rate to be paid on the debt, if improved investor confidence comes with it.
  - Is it widely used? Almost all debt reduction processes, apart from those arising from processes of hyperinflation, have included, to a greater or lesser extent, fiscal consolidation. They have generally been more successful when supported by spending cuts rather than tax increases.
  - Assessment: It would be difficult to find a country that doesn't have margin for improvement in the efficient of spending and raising taxes. Nevertheless, errors in the intensity or focus of the measures could lead to a deterioration of growth that would reverse the progress made in cleaning up the public accounts (don't forget that the most important thing is the debt/GDP ratio; it is possible to reduce debt and, at the same time, make the ratio worse).
  - Is it a feasible mechanism today? In the West, particularly in Europe since the Great Recession, fiscal consolidation = austerity (if not "austericide"). Significant cuts in public spending are going to be very

<sup>17</sup> Interested readers can find a detailed and interesting response in Simon, J. (team leader); Pescatori, A. and Sandri, D. (2012); "The Good, the Bad and the Ugly: 100 Years of Dealing with Public Debt Overhangs", *IMF World Economic Outlook*, October. Chapter 3. Or, more recently, in Eichengreen, B.; El-Ganainy, A.; Pedro.Esteves, R. and Mitchener, K-J. (2019); "Public Debt through the Ages", *IMF WP/19/6*.

difficult to implement politically. There may be greater political margin for increasing taxes, but they must target the objectives, because the economic cost of certain proposals could be very significant. In the rest of the world there is plenty of margin for the reorientation of spending. Increasing revenues is very complicated where the middle class is not the dominant stratum<sup>18</sup>.

- *Increasing inflation*: as explained above, increasing effective inflation with respect to the level forecast reduces the real value of debt and constitutes a transfer of income from the investors to the government, insofar that the compensation for inflation (forecast rate) incorporated into the interest rate paid by the debtor is lower than real inflation. Furthermore, with the fiscal systems not fully indexed, nominal increases in revenue (offsetting higher inflation) constitute an increase in tax revenue where individuals and companies don't improve their real income.
  - Is it widely used? Very frequent throughout history both in the remote past and more recently, given its attraction for the State.
  - Assessment: Certainly, the existing debt is cut more effectively the higher the rate of inflation reached. But it comes with serious costs in terms of subsequent access to the markets, as well as the problems of inflation itself. And let's not forget that in almost all countries, the majority of debtholders are persons (especially those of a certain age) and domestic institutions (banks). Inflation in excess of forecasts levels is but a tax on these groups, whose incomes suffer.
  - Is it a feasible mechanism today? Most unlikely, and with a lower chance of success than in the past. Firstly, most Central Banks have an explicit mandate to keep prices stable. Secondly, there are significant sections of public debt (debt indexed against inflation, short-term debt, debt in strong currencies) for which allowing excessive inflation would have little effect, if not a counter-productive effect, even in the short term. Thirdly, in a globalised world, penalising investors through what remains a deceitful tactic could prove more costly than ever.
- *Financial repression*: use of mechanisms (from forcing the acquisition of public debt on the part of national institutions at limited rates to impeding the purchase of gold, an alternative safe asset to public debt, through the prohibition of selling debt) to facilitate and cheapen the placement of higher volumes of debt at lower costs than investors would like.
  - Is it widely used? It was used quite frequently in the past, but much less in recent times.
  - Assessment: It conceals the problem and transfers it to the private sector rather than resolve it.
  - Is it a feasible mechanism today? Unthinkable for developed countries that enjoy privileged financing among other things precisely because these practices are not on the table. Enormously risky for other countries and would guarantee severe penalties in terms of access to financial markets in exchange for short-lived gain.
- *Sale of public assets*: the allocation of funds received from the divestment of public assets is a direct mechanism for reducing debt, although it usually results in a reduction of future revenues that these assets would provide.
  - Is it widely used? It is often used although not systematically and generally as a secondary measure.
  - Assessment: Useful when seeking other objective through privatisation (improving efficiency, increasing competition, reducing corruption and cronyism). Much less as a fiscal correction mechanism insofar that it is an advance of revenues rather than an increase thereof.
  - Is it a feasible mechanism today? There is minimal margin in developed countries. There are barely any public assets left that are attractive for investors (as discovered in Greece during the last crisis) and part of them are considered strategic. Greater margin in the rest of the world, although all too frequently privatisation has yielded less than the true value of the asset for the country. That's the problem with emergency sell-offs.
- *Default*: non-payment / restructuring, partial or total, voluntary or forced, of commitments acquired with

<sup>18</sup> It is well known that “those at the top don't pay because they don't want to, those at the bottom because they can't and those in the middle because they don't exist”.

debtholders is clearly the most drastic way of reducing debt and the most costly.

- Is it widely used? Although it is assumed to be a last resort, when the other options are not feasible, restructuring processes have long been the order of the day. Partial restructuring processes are more frequent. With regard to their voluntary nature or otherwise, that depends very much on how the observer defines “voluntary”.
- Assessment: It should be effective as a last resort, although in quite a few cases the other options are exhausted on political or social terms rather than economic ones (there is, after all, a limit to what a country can accept in terms of socio-political stability to continue paying, even if, technically, it can generate the resources to do so). Where default affects external creditors it will likely result in exclusion from international capital markets for a period (and lack of access to a saving that could prove vital), as well as more expensive financing in the future. If default affects domestic citizens and institutions, we can reiterate what we have already stated in relation to excess inflation: it is a stealthy and skewed tax.
- Is it a feasible mechanism today? It will remain inevitable especially in the emerging world, where there are several restructuring processes underway. That doesn’t make it any more desirable.

### ***Conclusions A brief proposal for the future***

Public debt levels, in the world in general and in the West in particular, excessive before the COVID-19 pandemic, are going shoot up as a response to the crisis. The sustainability of this public debt, as we have explored, depends crucially on interest rates remaining at historically low levels, together with massive acquisitions of this debt on the part of the Central Banks. These actions of monetary authorities have costs, and considerable ones, that we’ll tackle in a future *Under the Microscope*, although it’s difficult to deny that, as of today, the reversal of this action by Central Banks would cause a global economic collapse. We have also reflected on the options that, looking back at History, have allowed for public debt to be reduced over time. What should the lines of action be at this time?

1. The opportunity offered by rock-bottom interest rates on the international capital markets for moderately safe debt, even over the long term, should be seized by States to design programmes that finance the transformation of the current growth model; of the “system” for those who prefer to deal in more grand terms. Recovering the dynamism of economic activity while other desirable ends are pursued, from sustainability to inclusion, must be the immediate horizon of all the most advanced developed and emerging countries, and sights must be set on longer terms for the rest, who in many cases have more immediate priorities. This is an objective that requires investment to the tunes of trillions of dollars. But the saving necessary is available. The EU Next Generation is one such example although rather timid in its dimensions. Public-private partnership will be essential in this process. By putting these actions in place as soon as possible, it would also be possible to remove the Central Banks they have been forced and which, in the word of Mohammed A. El-Erian, is “the only game in town”: propping up the entire economic framework. The progressive, albeit slow, normalisation of monetary policy would at the same time allow for containment of the risks and problems that arise from the unchecked expansion that has continued for more than a decade.

2. Although they are reviled terms in certain quarters and for certain political groups, the rationalisation of public spending, eliminating duplications and inefficiencies, and pending structural reforms, different in each country, are elements that will contribute to greater growth and the reduction of public debt levels.

3. The closure of loopholes that allow for tax evasion is essential as part of this agenda. This means:

a. Effective and coordinated taxation of activities with negative externalities for society (green taxes).

b. Prevent large companies from using complex (and legal) mechanisms involving different countries to pay miniscule taxes, which not only strips Governments but destroys relatively balanced competition (it will never fully be so) with small and medium-sized enterprises, breaking one of the central tenets of the capitalist system.

c. Combating the black economy. It’s not a survival mechanism, it’s a scam committed against the part of society that fulfils its tax commitments. If the undeclared economy (10% in the most compliant countries, 20-30% in southern Europe and much more in the non-developed world) were to come to the surface, average taxes could be reduced for everyone.

4. If we really consider the current crisis to be a sudden, exceptional situation for which the blame cannot be

attributed to countries, an exceptional financing mechanism should probably also be considered. As pointed out in the last Quarterly Report, the option of compartmentalising the increase in debt arising from the fight against the pandemic and issuing this debt on a perpetual basis should be considered. At least in the West, with interest rates in and around 3%, it would be an attractive product that offers a real yield for investors,<sup>19</sup> because it is highly unlikely that inflation will reach that level in the future aside from sporadic moments and, with the rest of the programme detailed, it would be simple to achieve nominal growth that more than exceeds this figure. With no return of the principal, the impact of the pandemic on public financing would be null.

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<sup>19</sup> Beyond the trading game on the secondary markets, simply maintaining it in the portfolio.

## Annex. Establishing the sustainability of debt

- Debt for a period is the sum of the debt of the previous period and the public debt in the year in question:

$$B_t = D_t + B_{t-1}$$

where B denotes public debts and D the deficit of the current fiscal year.

- If we differentiate payment of interest on the debt from the rest of public spending we have:

$$B_t = DP_t + (1 + r_t) B_{t-1}$$

where DP is the primary deficit (total deficit excluding interest payments) and r is the average interest rate (nominal) paid on live debt.

- Introducing economic growth and expressing everything in relation to GDP (we use lower case letters to denote that debt and deficit are now expressed in this manner), and after a simple mathematic transformation we find

$$b_t - b_{t-1} = dp_t + (r_t - g_t) b_{t-1}$$

where g is nominal GDP growth.<sup>20</sup>

- Supposing that debt is being paid in the manner expected in the year t-1 to keep the debt/GDP ratio stable, guaranteeing sustainability, the following equation should be fulfilled.

$$-dp_t = (r_t - g_t) b_{t-1}$$

- Conceptually, therefore, the debt/GDP ratio is kept stable if the sum of the primary deficit and the difference between the cost of the debt and growth (multiplied by the previous level of debt) is equal to zero, the debt is reduced if the sum is negative and increases if the sum is positive. Therefore, debt is sustainable if the following two conditions are met:

- There is a primary budget surplus
- The nominal growth in GDP exceeds the average nominal interest rate paid on the debt.

Where only one of the conditions is fulfilled, the above equation should be fulfilled. If none of the conditions are fulfilled, debt is heading in a direction that could lead to unsustainability.

<sup>20</sup> Note that it is important that the interest rate and GDP in this equation are incorporated in nominal terms, given that inflation to be considered is not the same. The inflation to offset when the rate of debt is established is the *forecast* rate, while the inflation in nominal GDP is the *effective* rate inflation. That explains why, historically, inflation has been used, by allowing it to accelerate, as a mechanism for reducing real debt (while real inflation rises, the forecast rate remains the same until the debt is renewed or new debt is issued). That results in a gain for the debtor (the States in the case of sovereign debt) and a loss for investors.



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Panellists:

