

Brexit, the pound, and the ECB's possibly risky verbal balancing act

This week saw Brexit tensions rise once again and we think there's at best a 50-50 chance of a deal between the UK and the EU. Read our reaction and download the podcast. Christine Lagarde engaged in a possibly risky verbal balancing act at the ECB. And what can other government's learn from the Dutch on spending and austerity?

In this bundle



FX | United Kingdom

Sterling unprepared as UK-EU trade deal hopes fade

The chances of a UK-EU trade deal being struck are now 50:50 at best, given the events of the past few days. The very limited risk premium factored into...

By James Smith



FX | United Kingdom

Listen: A no deal Brexit is no 'cliff edge' for the UK economy (but it won't help)

Concern that Britain could leave the EU without a trade deal has weighed on the pound this week. But how much difference would a trade deal really make?...

By James Smith and Rebecca Byrne



ECB: The risky verbal balancing act

The ECB carried out an interesting verbal balancing act, which doesn't come without risk. We think the ECB seems to be concerned about the stronger...

By Carsten Brzeski

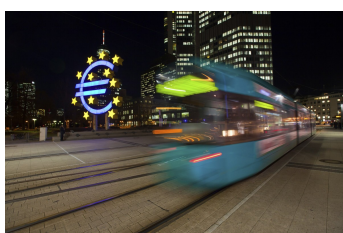


The Netherlands

Covid-19: Spending, austerity and the Dutch experience

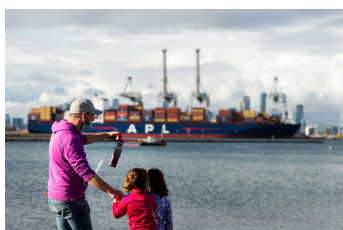
Dutch public finances provide ample room for temporary fiscal stimulus in the Covid-19 crisis and support for fiscal austerity is waning among economists....

By Marcel Klok and Marieke Blom



Striking differences in Eurozone business borrowing during Covid-19

Eurozone businesses borrowed heavily in the early lockdown months, but liquidity needs have come down substantially since then. Differences between...



The threat to world trade from Covid-19 subsidies

Governments worldwide have implemented subsidies to rescue their economies from the effects of Covid-19. These measures provide essential support to...



Don't be fooled by public consumption figures

Differences in measuring public consumption have exacerbated growth differentials in Europe. France and the UK, in particular, are likely to see a...

By Charlotte de Montpellier and Peter Vanden Houte

Sterling unprepared as UK-EU trade deal hopes fade

The chances of a UK-EU trade deal being struck are now 50:50 at best, given the events of the past few days. The very limited risk premium factored into...



British Prime Minister, Boris Johnson, leaving Downing Street

The chances of a deal have receded

The UK government's unveiling of its Internal Markets Bill marks the start of what promises to be another messy period in the Brexit saga. Provisions contained within the bill to effectively disregard parts of the withdrawal agreement have undoubtedly reduced the chances of a deal, and we think at best the odds of a free-trade agreement being reached this year are now 50:50. For sterling, this is likely to mean further downside ahead. No trade deal could see EUR/GBP trade above this year's high of 0.95.

What follows is an explainer of what's been happening, and what it means for the chances of a deal and the pound.



State aid is the UK government's main concern

State aid is the dividing issue in Brexit talks, and the UK government is keen to retain a free hand to support British industry once the transition period has ended. The EU, in contrast, wants adequate reassurance - if not in the form of ECJ oversight, then perhaps via an independent regulator - that the UK won't abuse state aid in a way that could put European firms at a competitive disadvantage.

But the UK's ability to engage in state aid is also bound to a certain extent by the terms of last year's withdrawal agreement. The government is obliged to follow EU rules on state aid rules where intervention might affect trade between Northern Ireland and the EU.

One concern in Westminster is that this could seriously restrict its ability to support companies in so-called industries of the future.

What does the Internal Market Bill do?

This appears to be a key motivation behind the legislation published by the UK government on Wednesday, which effectively seeks to give ministers powers to disapply the state aid provisions contained within the Northern Ireland Protocol - the formal name for what was once termed the Irish backstop.

It also looks to override the terms of this agreement on the need for customs declarations and tariff payments on goods crossing the Irish Sea.

Does this kill the chances of a deal?

Despite some talk that the government might water down the powers granted by the bill, the published legislation is perceived to be just as incendiary as was reported in the [FT](#) over the past few days. And ministers have made no secret of the fact that these moves could leave the UK in breach of international law.

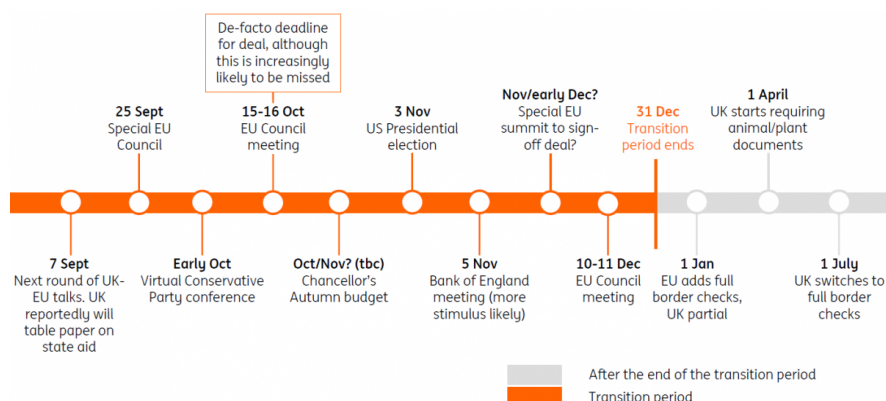
This raises a few questions.

Firstly, what will the EU make of all of this? So far, the response has been relatively cautious. Brussels hasn't formally said it will suspend talks. And according to the [Irish Times](#), the view in Dublin is that the bold nature of this newly-published legislation means it is most likely "sabre-rattling". The EU has however since called a meeting of the 'joint committee', which was set up to fill in the blanks in the Northern Ireland protocol agreed last year.

Secondly, there's a clear question mark over how the House of Lords will treat this legislation. A number of political commentators have highlighted that the bar is pretty high for it to pass, given concerns about abiding by the law.

Thirdly, there are some faint parallels with what happened this time last year. Parliament was prorogued, a move that was later ruled to be unlawful by the Supreme Court. And while there is still plenty of discussion about exactly what the goal of all of that was, it may well have been partially designed to inject some pressure, or a sense of crisis, into negotiations. Whether or not this tactic contributed to the agreement of a revised deal last October is of course debatable.

The latest Brexit timeline



Source: ING

Don't write off the chances of a deal

The upshot is that despite all of this latest drama, we probably shouldn't completely write off the possibility of a deal being done at the eleventh hour, although there's little doubt the probability has diminished.

The Internal Market Bill is likely to diminish trust even further between negotiators, and the EU will be very wary of signing a free-trade agreement while there's a risk that the UK could go back on its earlier commitments.

Equally, while some of the above may indicate that the government isn't completely against a deal, at least not as much as the recent fireworks would seem to imply, PM Johnson has also publicly indicated that he doesn't believe 'no deal' would be a disaster.

And that leads us to a potential counterpoint to the 2019 vs 2020 argument above. The 'compromise' PM Johnson reached with the EU last October in effect moved the needle towards a more arms-length future relationship, the kind of agreement he was arguably more comfortable with. The change from PM May's deal meant that the UK would no longer remain permanently in a customs union with the EU.

This year, it's a different story. A compromise would involve ceding some control on state aid, if not directly to the EU, but to an independent regulator, and as we know, the UK government is highly reticent to do so.

So where does all of that leave us in terms of probabilities?

In honesty, we think it's pretty much 50:50 now, and perhaps the bias is if anything towards 'no trade deal' at this stage.

But either way, we think the de-facto mid-October deadline will be most likely be missed. The jury's out on how much longer talks can run, be it in public or behind closed doors (the so-called 'tunnel'), while still allowing some time to ratify a deal if there's going to be one. There's a growing sense though that the saga could easily stretch into November

With-or-without a trade deal in place, the end of the transition period will herald a raft of

new costs for businesses, and that's likely to drag on the post-Covid recovery. [Read our economic analysis](#) in our latest monthly economic update

□ GBP: Limited risk premium means potential for further downside

We continue to see GBP as unprepared for the stream of downside risks ahead discussed above, and following the market complacency during the summer months, we estimate that only a limited degree of risk premium, as you can see below, is priced into the currency (just around 1% in EUR/GBP vs 5% risk premium pricing in late June). This allows for a further GBP decline.

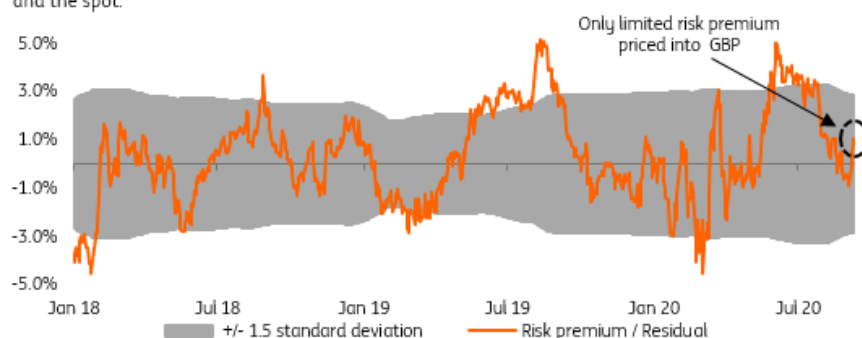
We look for EUR/GBP to break the multi-month high of 0.9176 in coming days. Not only is a limited degree of risk premium is priced into GBP, but the speculative positioning does not seem stretched (the latest CFTC data still show a neutral positioning in GBP/USD), in turn allowing for a build-up in GBP shorts which would help facilitate further GBP downside.

As we noted in this article, [GBP: Summer is over, brace for the reality check](#), should there be no trade deal, we expect EUR/GBP to break above this year's high of 0.95 and potentially test parity.

Indeed, even with a limited deal in place, the change in UK-EU trade terms would leave the UK at risk of a slower recovery versus its peers, taming the potential medium-term upside to both GBP spot and its fair value. In the case of no trade deal being agreed, such a trend would gain even more traction and, coupled with the likely response and more easing from the Bank of England, which could include the possibility of negative interest rates, the outlook for sterling would clearly deteriorate and the currency would come under further pressure.

EUR/GBP risk premium

The estimate of the EUR/GBP risk premium. Residual between EUR/GBP short-term financial fair value and the spot.



Source: Bloomberg, ING

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Listen: A no deal Brexit is no ‘cliff edge’ for the UK economy (but it won’t help)

Concern that Britain could leave the EU without a trade deal has weighed on the pound this week. But how much difference would a trade deal really make?...



The UK government this week changed some of the provisions in its divorce agreement with the EU, putting strain on already tense relations with the bloc and threatening to undermine a trade deal. [In this podcast](#), ING's Developed Markets Economist James Smith tells Senior Editor Rebecca Byrne that whatever happens, disruption is on the way. But a sharp plunge in GDP is unlikely.

Authors

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Snap | 10 September 2020

ECB: The risky verbal balancing act

The ECB carried out an interesting verbal balancing act, which doesn't come without risk. We think the ECB seems to be concerned about the stronger...



Source: Shutterstock
Christine Lagarde

As expected, the ECB did not change its monetary policy at today's meeting, however, there were three issues of high interest to financial markets, which ECB president Christine Lagarde addressed during the press conference: the latest staff projections, the ECB's possible answer to the Fed's policy shift towards average inflation targeting and, of course, the central bank's reaction to the stronger euro.

Here are our key takeaways:

- The easiest one was the ECB's reaction to the Fed's policy. Here Lagarde didn't give away anything, pointing to the fact that the review has only just started.
- With regards to the fresh round of macroeconomic projections, the ECB staff revised their 2020 GDP growth projections upwards to -8.0% and kept the 2021 and 2022 projections broadly unchanged at 5% and 3.2% respectively. The ECB still believes in a significant rebound of the eurozone economy but at the same stresses the high level of uncertainty.
- With regards to inflation, the meeting provided remarkable information. The projections for

2020 remained unchanged at 0.3%, while those for 2021 were revised upwards to 1.0% and projections for 2022 remained unchanged too at 1.3%. Interestingly, however, Lagarde emphasised that 2022 projections masked an upward revision of core inflation.

- The key moment of today's press conference was Lagarde's first mentioning of the euro exchange rate as a factor that the ECB will carefully assess in the coming months. Also, Lagarde mentioned that the Governing Council had discussed the strengthening of the euro "extensively" and that the euro was a dampening factor for inflation. At the same time, Lagarde pointed out (again) that the exchange rate was not a target for the ECB but obviously an external factor impacting monetary policy. Interestingly, the ECB did not mention the exchange rate as a dampening factor to growth.

Our feeling is that the ECB today engaged in an interesting, possibly risky, verbal balancing act.

Mentioning the exchange rate in its introductory statement for the first time in more than two years and stressing upward revisions of the (underlying) inflation forecasts could eventually even trigger more euro strengthening.

This means the ECB seems to be concerned about the stronger euro but not too concerned just yet. At least not everyone at the Governing Council.

Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Covid-19: Spending, austerity and the Dutch experience

Dutch public finances provide ample room for temporary fiscal stimulus in the Covid-19 crisis and support for fiscal austerity is waning among economists....



Source: Shutterstock

Prime Minister of The Netherlands Mark Rutte

The Netherlands earned a reputation for prudence after the financial crisis

Like other governments across the world, the Dutch government responded to the global financial crisis with a stimulus package, but a few years later the Netherlands, often together with Germany, became famous, if not infamous, for significant austerity and reform measures, and strong advocacy for such policies.

Initially, there was a lot of support for this approach among Dutch politicians and even the general public. Many Dutch economists argued in favour of cutting expenditure and increasing taxes, supporting the government for its “fiscal prudence”. Support was certainly not unanimous, but those warning against the impact of prudence were then still in a minority.

In the end, the Dutch economy experienced another recession in 2012-2013 and only saw GDP climb back to its pre-crisis level in 2015.

Taking the long-term perspective on sustainability

In the years that followed, business cycle momentum picked up further and public debt started to fall quickly, leading to a low public debt ratio of about 49% of GDP in 2019.

During this period, ING Economics Research discussed how Dutch public finances should be viewed with a number of academic economists, and in particular which indicators are relevant in both good and bad times. At the time, many economists emphasised the importance of having a long-term perspective on the sustainability of public finances.

They also stressed that in times of crisis, confidence indicators in financial markets should be monitored alongside the sustainability balance, given that the European sovereign debt crisis had made financial stability a core part of the debate. The possibility of rising risk premiums on Dutch government debt still played a significant role in the debate in 2017. Via this channel, higher government spending would risk becoming ineffective by crowding out private spending.

[Download our 2017 report in Dutch here](#)

Consensus about initial reaction to support the economy

As Covid-19 has made new demands on public finances, here at ING we've conducted another round of interviews with eleven Dutch-speaking academic experts on topics around public finances and macroeconomics. Among those we interviewed there was unanimous consensus about the large fiscal support packages that the Dutch government has delivered up to now.

Given the economy experienced an abrupt and large disruption, which is expected to be temporary, the government was right to limit the economic damage. Many of the economists mentioned keeping unemployment low as an important short-term goal.

[Download the report in Dutch here](#)

More than enough room for temporary support

According to these economists, the increases in public debt associated with the support measures are not a concern. Because annual revenues and expenditures in the Netherlands are roughly in balance, the public debt ratio (public debt as % GDP) increases only as a one-off as a result of the temporary support measures.

Even after the additional support package (the third announced on 28 August for the period between October 2020 – June 2021) the debt ratio is expected to remain at an acceptable level.

Many economists think there is no identifiable hard limit for the public debt ratio

Many economists that we interviewed think that there is no identifiable hard limit for the public debt ratio, but some mentioned 70%, 80% or 90% of GDP as safe limits. According to the latest

official forecasts by the Netherlands Bureau of Economic Policy Analysis – the debt ratio remains only at 60% GDP in 2020.

A rising risk premium is not seen as the most relevant factor currently to take into account.

No rush towards austerity now

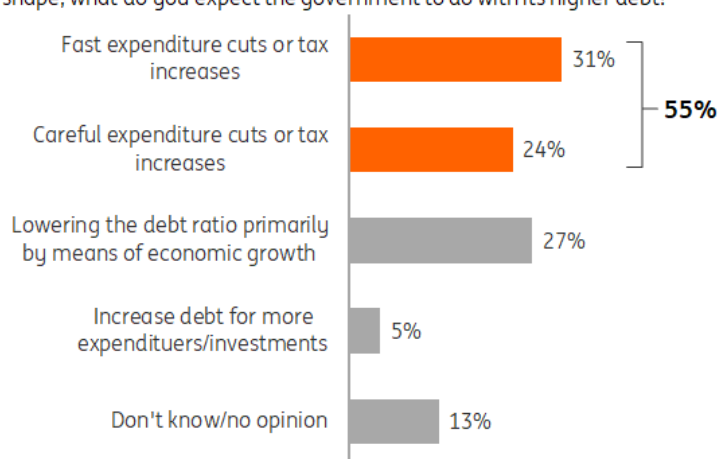
But what should we expect when the Covid-19 crisis is over?

Based on the austerity experience in the aftermath of the global financial crisis, the majority of ING’s daily poll of retail clients expect the government to cut expenditure or raise taxes again when the economy is in better shape, suggesting a view among the wider public that austerity will resume.

Expectations of austerity

Majority of consumers expect the Dutch government to turn to austerity when the economy is in better shape after the covid-19 crisis

Share of respondents on the question "When the economy in a better shape, what do you expect the government to do with its higher debt?"



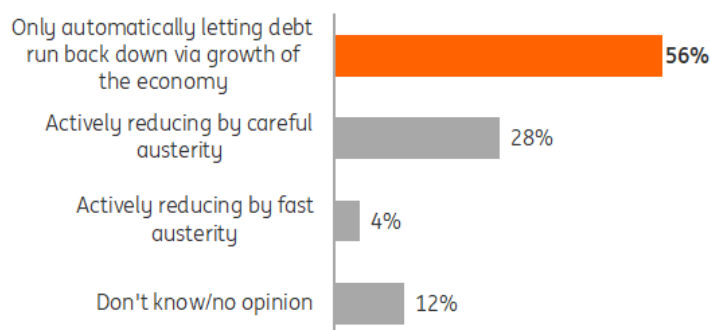
Source: ING Vraag van Vandaag - Saturday 25 July 2020 - 8.959 respondents in the Netherlands, weighted by age, region and sex

However, consumers do not want active austerity measures after the crisis. The majority prefer letting debt run back down automatically through the growth of the economy, counting on automatic stabilisers rather than discretionary policy.

What to do about debt

Majority would like to rely solely on automatic stabilisers for public finances to improve after the Covid-19 crisis

Share of respondents on the question "What do you think the government should do with its incurred debt after the Covid-19 crisis?"



Source: ING Vraag van Vandaag - Monday 27 July 2020 - 12.852 respondents in the Netherlands, weighted by age, region and sex

Economists are divided on whether government expenditure should be lowered actively beyond the expense of support measures after the Covid-19 crisis. Some economists support waiting until the economy can stand on its own feet again before terminating government support programmes, but would then start to actively reduce debt. The reasoning is that this would create a buffer for the next recession – a debt to GDP ratio well below 70, 80 or 90% GDP.

Those asking for discretionary measures call for a very gradual approach, with some saying lowering the debt burden could be spread over multiple decades. Another group of economists claim that no discretionary interventions are necessary at any point. All in all, amongst economists there is no support for significant interventions in the short term to repair public finances.

None of the economists we interviewed is currently worried about Dutch public finances, in part because of the low-interest rate and solid economic and fiscal fundamentals.

Disagreement about future support and concerns about productivity support

There may be ample room for continued fiscal support, but there is a real difference in opinion among economists about the role of government in such continued support in the near future. The economists we interviewed are concerned about productivity in the longer term, not least because it determines the future tax base.

A crucial question is whether the economy will manage to recover production that has been lost

A crucial question is whether the economy will manage to recover production that has been lost. Many of the economists fear we won't be able to catch up with that even when the economy starts growing again, leaving some output and income permanently lost (see the orange line in the

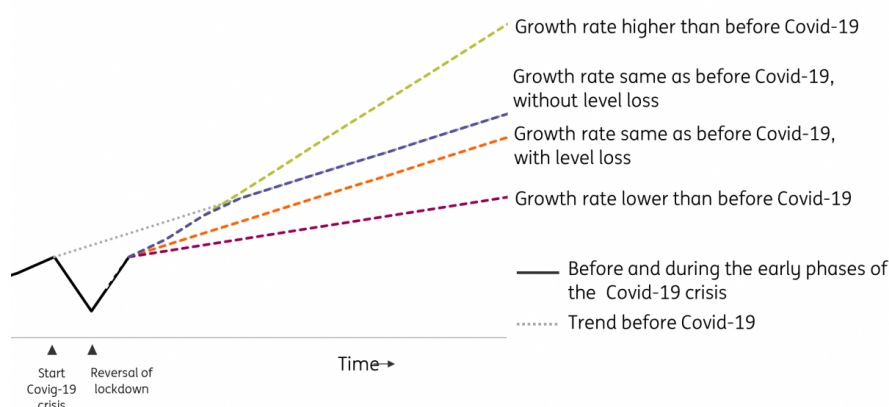
chart). Some of the economists even see the possibility that productivity will grow more slowly, making the losses grow each year (as you can see in the purple line).

Although the economists could not exclude the possibility of a full recovery and even a boost to economic growth, mostly due to increased digitisation, there are a few who attached a high likelihood to these scenarios.

Covid-19's long lasting effects

Crisis can have a long-lasting effect on size and growth rate of the economy: several scenarios possible

Possible level of (structural) gross domestic product (stylised representation)



Source: ING Economics Research

Some economists view reallocation as an urgent priority

One group of economists takes the view that it's about time to restructure the economy, involving workers and firms starting to focus on areas with more long-term growth potential.

These economists point to the fact that the crisis may last a long time and has already led to behavioural changes which could be permanent, such as more working from home and online shopping. They emphasise that restructuring promptly will yield more economic growth over the long run. They stress the need to reallocate the means of production from existing activities to growing sectors and businesses as soon as possible.

This requires the timely unwinding of public support measures. They believe that freezing the economy in its pre-Covid-19 state in the end is more of a drag to productivity than the temporary loss of production that comes with disruptive restructuring.

Other economists seek to limit unnecessary structural damage

An opposing view highlights the risk of terminating too quickly the government's support to the economy. In this view, the bulk of economic activities from the 'old' economy is still viable, and will unnecessarily be lost for good if they are not temporarily helped to survive.

The biggest risks to long-term productivity arise from unemployed workers losing skills and knowledge, and innovations and investment being put on hold in the case of a fast reduction of government support.

The networks which produce and distribute goods and services may be destroyed if they are not maintained. All of which needs to be reinvested after the crisis if public support packages are terminated too soon.

Better to be safe than sorry

In our view, at this stage of the Covid-19 crisis, it is better to be safe than sorry.

The potential damage caused by withdrawing government support too early is much larger than the potential upside of earlier reallocation. Assuming that the virus is brought under control and social distancing measures are eventually phased out, this will mean many 'old' business models will be fully viable again. Providing government support to the economy now will save production capacity and skills having to be built back up from scratch.

The gradual change in opinion in the Dutch economy is relevant for international debate too

It is still unclear which skills, knowledge, goods and services have a place in the post Covid-19 economy, but there will come a point where this is easier for all agents in the economy to see. Some reallocation will eventually have to happen and that is also good for long-term productivity. However, it is easier to start new businesses, perhaps with new business models, when aggregate demand is stronger than while uncertainty about the new normal remains high and demand is weak.

Extending government support will delay the required transition (of shopping streets, for example). However, it will still happen, so the impact on productivity growth will take effect, albeit a little later. And last but certainly not least, supporting the economy for an extended period prevents a lot of human suffering, since research shows that unemployment has a major impact on human well-being.

The gradual change in opinion in the Dutch economy is relevant for international debate too. Since opinion on public finances shows fewer signs of public debt aversion than we have seen previously, especially in politics.

Premature austerity in the Netherlands seems much less likely than during the global financial crisis.

Acknowledgement

The following economists were interviewed but the final conclusions are entirely those of ING Economics Research.

<u>Name economist</u>	<u>Affiliation</u>
Prof. dr. Roel Beetsma	Universiteit van Amsterdam
Prof. dr. Willem Buiter	Columbia University as visiting professor
Prof. dr. Frank den Butter	Vrije Universiteit Amsterdam
Prof. dr. Casper van Ewijk	Universiteit van Amsterdam
Prof. dr. Paul de Grauwe	London School of Economics
Prof. dr. Lex Hoogduin	Rijksuniversiteit Groningen
Prof. dr. Bas Jacobs	Erasmus Universiteit Rotterdam
Prof. dr. Clemens Kool	Universiteit van Maastricht
Prof. dr. Coen Teulings	Universiteit van Utrecht
Em. prof. dr. Harrie Verbon	Universiteit van Tilburg
Prof. dr. Sweder van Wijnbergen	Universiteit van Amsterdam

Authors

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Marieke Blom

Chief Economist and Global Head of Research

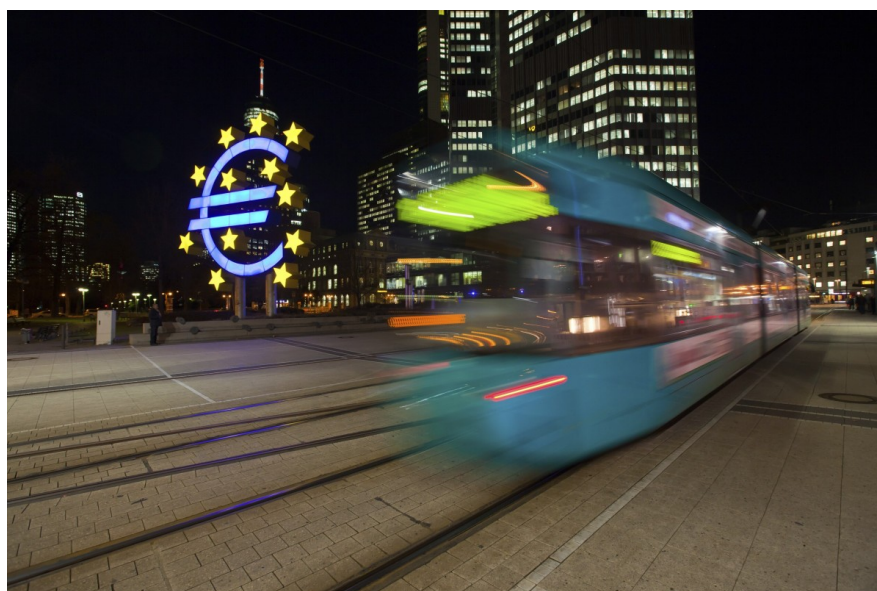
marieke.blom@ing.com

Article | 11 September 2020

Striking differences in Eurozone business borrowing during Covid-19

Eurozone businesses borrowed heavily in the early lockdown months, but liquidity needs have come down substantially since then.

Differences between...



Business financing back to normal?

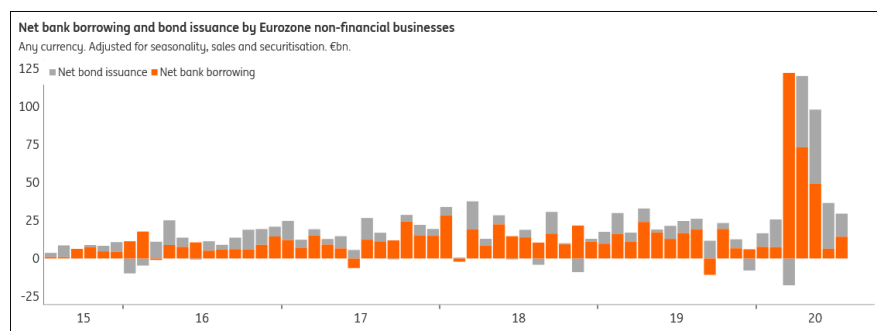
In the early months of the lockdown, Eurozone non-financial businesses faced acute liquidity stresses and borrowing from banks hit record highs as credit lines were drawn. Non-financial businesses borrowing from banks reached €122bn in March, almost double the previous monthly record of €68bn, set in December 2007. April and May saw strong net borrowing as well, and businesses also started to tap bond markets in substantial amounts.

Figures conceal distinct country differences in where businesses get their liquidity from

By then, some of the bank credit lines drawn out of precaution were being repaid, and borrowing at banks returned to "normal", though bond issuance remained elevated. But of course, nothing is "normal" right now. Eurozone aggregate financing figures conceal distinct country differences in

business reliance on bank loans vs bond issuance vs government emergency liquidity. In turns, this drives different expectations for financing needs in the future. Let's have a closer look.

Eurozone bank loans by sector



Source: ECB, Macrobond, ING Research

Stark differences between Eurozone countries

Looking at the larger Eurozone economies, the demand for bank loans has remained elevated especially in Italy and France, and initially also in Spain, as you can see in our chart 'fest' below. In Italy, businesses hardly did any bond issuance in net terms. This should not surprise us, given the relatively high share of SMEs with no access to capital markets in Italy. Instead, reliance on bank loans remained elevated until July (the latest month for which data is available). The fact that approval procedures for guaranteed loans were complex initially, but simplified over time, may also explain the prolonged demand for bank loans.

The contrast with Germany, Belgium and the Netherlands is stark

The contrast with Germany, Belgium and the Netherlands is stark. In these countries, bank borrowing fell back after the initial surge and even turned negative in the summer. Larger businesses, instead, tapped bond markets. France is truly in the middle: both bank borrowing and bond issuance remain strong. A number of country-specific characteristics play a role in the observed country differences, but we highlight three overarching themes here.

Net bank borrowing and bond issuance by non-financial businesses



● Bond issuance. ● Bank borrowing. Adjusted for seasonality, sales and securitization (€bn)

Source: ECB, Macrobond, ING Research

1 Three important things to note

The severity and economic impact of the lockdown was generally bigger in Southern Europe than in northern countries. Given the sectoral composition of economies (e.g. the reliance on tourism), the summer recovery was likely quicker in the north.

Although government support packages are difficult to compare across countries, it appears that the German and Dutch governments, in particular, provided generous tax deferrals (delayed payment of VAT and corporate taxes). Insofar as businesses could rely on "tax credit", they did not need liquidity from their banks. Estimates on the size of the liquidity provided by taxes not paid vary but, for example in the Netherlands, this source of liquidity since March appears at least as big as the financing obtained from banks and bonds combined.

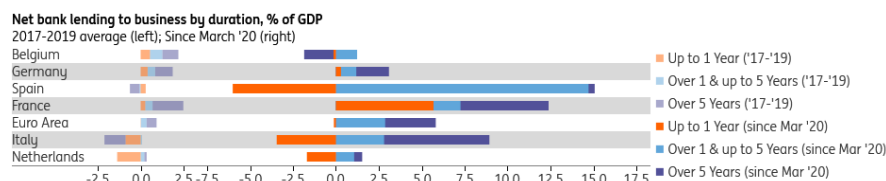
[Bruegel dataset](#) on government support packages (be careful though, as loan moratoria are counted as "tax deferral", which, for example, confusingly pushes up the Italian numbers).

In Italy in particular, the government chose to provide liquidity mainly by guaranteeing bank loans and putting in place loan moratoria with partial government guarantees. This makes Italian business more reliant on bank liquidity, as opposed to deferred tax liquidity. That would explain both a bigger need and increased preference for these loans compared to other countries.

Further support for this hypothesis is given by the fact that Italian bank lending has been shifting towards longer durations since March. The chart below shows a marked shift from durations shorter than 1 year to the 1-to-5 year segment, and even above the 5-year level. We see a similar shift in Spain. The Netherlands also saw a decrease in shorter duration loans, but this decrease was already ongoing before Covid-19 and thus does not correlate with corona-related government support packages. Germany, France and the Eurozone as a whole do not show a clear duration shift. This suggests to us -- though by no means proves -- that government guarantees and loan moratoria invited stronger reliance on bank loans in Italy and, to a lesser extent, Spain.

Eurozone gross v net lending

Note the decline in the Belgian >5y figure is entirely driven by a sale/securitisation in July, and does not reflect an actual decline in long-term loans outstanding.



Any increase in business demand for finance remains contingent on economic developments

It's good that we get to understand a bit more what drives observed country business credit differences you say, but what about the future? It was clear from the start that emergency support could not last forever. Moratoria have ended or are ending. Going into 2021 we will see a reduction or even a phasing out of government support. Businesses will find that deferred does not mean condoned, and those taxes will have to be paid after all. The phasing out of various sources of liquidity will be difficult for businesses that were already struggling. Layoffs and bankruptcies are bound to increase at some point. Banks and other creditors will be confronted with loan defaults. Lenders have been preparing for this by taking provisions.

Businesses will find that deferred does not mean condoned, and those taxes will have to be paid after all

Other businesses may react to reduced government liquidity by (further) postponing or cancelling

investment plans, and/or by increasing bank borrowing (and bond issuance). Therefore, notably for those countries with currently generous tax deferrals and wage subsidies, demand for bank loans and, to a lesser extent, bond financing may increase more if and when government measures are phased out compared to countries with less extensive government packages. How strong this increase in demand will be, however, is highly uncertain at this stage. The weaker the economy, the less companies will want to invest and borrow. As we set out in our [Monthly Update](#), the further development of the virus and the timing and distribution of any vaccine are key to economic developments, which in turn drive financing needs.

Article | 10 September 2020

The threat to world trade from Covid-19 subsidies

Governments worldwide have implemented subsidies to rescue their economies from the effects of Covid-19. These measures provide essential support to...



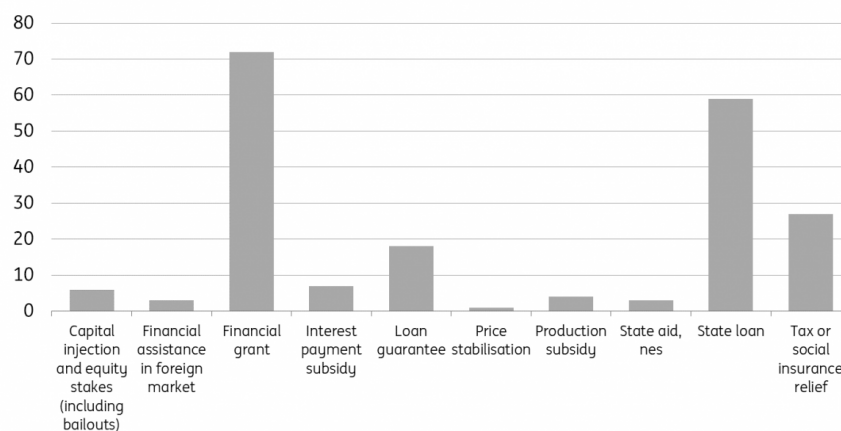
A masked man with his daughters look at a container ship in Melbourne

Essential support in a crisis

Governments worldwide have implemented subsidies as part of their responses to Covid-19, to bridge the drop in demand caused by lockdowns and continued social distancing. In total, additional spending and foregone revenue in G20 countries are equivalent to 6% of their combined GDP. Another 6% has been injected to boost liquidity through loans, equity and [guarantees](#).

Global Trade Alert records more than 200 different subsidies granted since March 2020, as you can see below. The most-used form of support has been financial grants, including the EU Commission's expansion of its Temporary Framework to allow financial support schemes. State loans and tax relief schemes have also been introduced in many countries with different target groups, often SMEs or firms in a particular region.

Governments have intervened in many different ways to fight the economic effects of the virus



Source: Global Trade Alert

The EU's Temporary Framework is a time-limited measure, which will run until December 2020 unless a further extension is agreed. However, two-thirds of the new subsidies have no end date. With this comes the risk that the subsidies introduced in the wake of Covid-19 open the door to negative long-term effects.

The trouble with subsidies

State support has been essential to keep firms going and avoid a devastating economic collapse. But the experience of the financial crisis showed that subsidies can have negative long-term consequences which play out through international trade [flows](#).

Subsidies can have negative long-term consequences

Subsidies act as a barrier to trade by reducing some firms' costs, which allows them to sell their goods for lower prices than their competitors without necessarily being more efficient or productive. Subsidies can also suppress demand for imports by enabling firms to afford higher-priced domestically-produced goods instead of cheaper imported goods and services.

In whichever form they take, subsidies risk giving an advantage to less efficient producers at the expense of more efficient ones. Over the long term, this can lead to lower productivity growth in the country implementing the subsidy. Subsidised industries may also lead to excess capacity and 'dumping' of goods on international markets, which damages exporters' prospects in other countries.

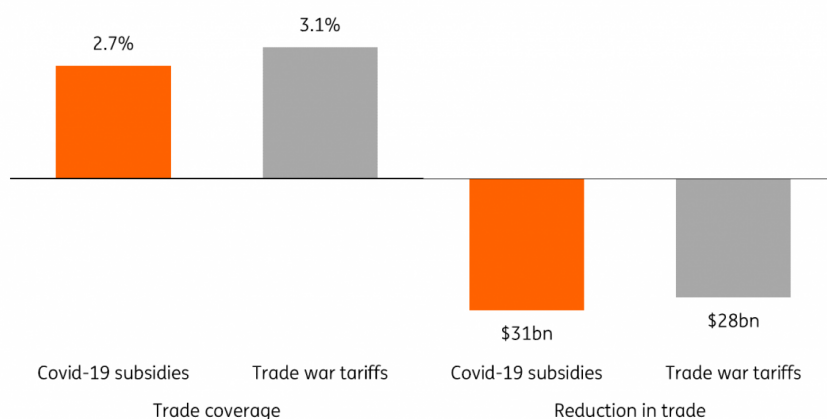
A silent trade war?

Not all subsidies will have an impact on international trade. Consumer services such as hairdressing and cultural activities have been particularly affected by lockdowns and ongoing social distancing

measures. Where subsidies are targeted towards these industries, the risks to international trade are low.

However, Global Trade Alert identifies thousands of traded products which are affected by new subsidies, around 3% of world trade in total. This is similar to the share of trade affected by the US-China trade war. Based on the effects of subsidies introduced in the financial [crisis](#), the potential hit to trade is similar to the net losses to date from the trade war between the US and [China](#),

Subsidies affect as much trade as the trade war and could cause a similar hit



Source: Global Trade Alert, UN Comtrade, ING calculations

Another headwind for world trade

Subsidies won't heap additional damaging uncertainty on the global economy in the way that the trade war has done. But worryingly for the global recovery from Covid-19, the effects of newly introduced subsidies fall most heavily on the engines of world trade growth, with emerging economy exports making up 60% of the flows affected.

As export-orientated economies, a recovery in exports is vital for these countries' recoveries, as well as world trade overall. This is especially the case following the capital outflows from emerging economies which happened at the beginning of the pandemic. Until these flows return, cancelled investment projects will leave domestic demand subdued, so export growth is needed to pick up the slack.

Governments' efforts to support their economies won't all affect world trade, especially where subsidies are targeted towards the activities that make little use of traded goods. But some measures risk creating another headwind for international trade, especially because most of the support is currently open-ended.

Article | 11 September 2020

Don't be fooled by public consumption figures

Differences in measuring public consumption have exacerbated growth differentials in Europe. France and the UK, in particular, are likely to see a...



Lies and statistics

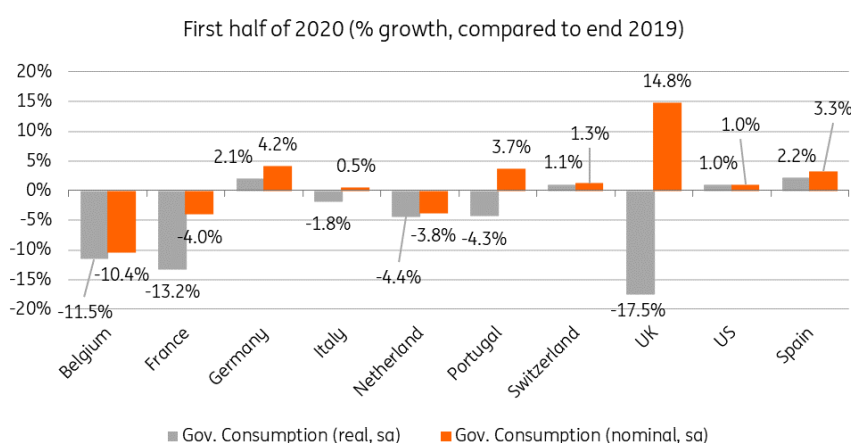
As the old adage goes, there are three types of lies: lies, damn lies, and statistics. In Covid-19 times, this is all the more true, because it has become a lot more difficult to collect economic data. GDP accounting is complicated anyway and one of the more contentious areas concerns the accounting for public consumption (think of expenditures for defence, education, public administration etc). Normally, GDP is computed at market prices. But for plenty of the services comprised in public consumption, there are no market prices. That is the reason why traditionally, they are accounted at cost. This brings some other problems. e.g. does a wage increase of public workers imply an increase in real GDP or is that just a price increase? Traditionally, statistical offices devised some rules of thumb to repartition cost increases between real growth (as some of the wage increase could reflect productivity gains) and inflation.

Not working, not counted

But how to account for lockdowns, when a number of public workers are actually paid, but unable to work? Should it be considered that the production of public services has followed its normal course because public wages have been paid? Or should it take into account the decline in activity and the fact that some public workers were unable to work? Enter Eurostat with an elaborate [note](#). To cut a long story short: “When hours worked are used as the indicator for labour input, changes in working time because of COVID-19 should result in volume changes in the output of non-market services. But if indicators like hours paid or full time equivalent employees are used, short term changes in activity may be not be captured. In this case, suitable adjustments to the indicators should be made, in order to better reflect the hours actually worked in the period concerned”.

The question is, which countries have bothered to make precise estimate of the change in the volume of public services. To be sure, there have been various types of lockdown and some governments may have decided to spend more or less on public services. But the interesting thing to focus on is the difference between nominal and real growth of public consumption. Barring a strong wage increase, growth rates should be of the same magnitude, the difference being the public consumption deflator. Looking at nominal and real growth of public consumption, some countries stand out: France, the UK and to a lesser extent Portugal. In France, the statistical office Insee estimated that 25% of public workers, health workers excluded, were unable to work during the lockdown. This has led to a 13.2% reduction in public spending in the first half of 2020. In the UK, the Office of National Statistics made output estimates for public services, resulting in a very big real decline in public consumption (-17.5%). Conversely, it seems that in other countries, such as Germany or Spain, the output of public services was considered to have been maintained as public wages continued to be paid.

It is interesting to note that Belgium and the Netherlands have also experienced a sharp decline in public spending. But for these two countries, the decline is both nominal and real, so it has nothing to do with the output of public workers. In fact, both countries have accounted in their public expenditure data for the sharp decline in the number of non-emergency medical treatments performed during lockdown.

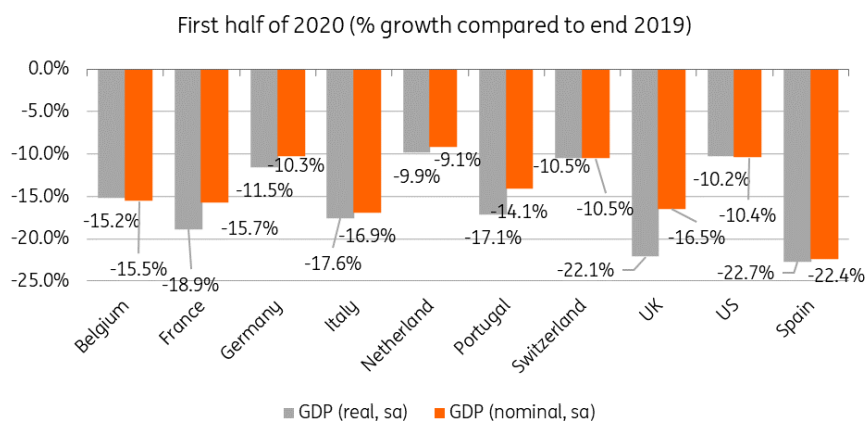


Source: Thomson Reuters, ING Economic Research

Comeback kids

Of course, these differences in accounting for public services has also had an impact on GDP

growth, with the difference between nominal and real GDP growth clearly much bigger in the UK, France and Portugal than in other European countries. The real GDP of these three countries is therefore calculated less favourably than the GDP of other European countries, and the recession in the first half of 2020 appears to be artificially deeper in France, the United Kingdom and Portugal than in the rest of Europe.



Source: Thomson Reuters, ING Economic Research

To measure the impact of these methodological differences, one can recalculate the evolution of GDP in the first half of 2020 by maintaining public expenditure at its level at the end of 2019 and compare this adjusted GDP with the observed GDP (see table). It appears, for example, that the French recession was 3.2 percentage points deeper than it would have been if INSEE had calculated the contribution of public expenditure to GDP as in Germany, Spain or Italy.

Belgium	-15.2%	-12.5%	2.6
France	-18.9%	-15.7%	3.2
Germany	-11.5%	-11.9%	-0.4
Italy	-17.6%	-17.2%	0.3
The Netherland	-9.9%	-8.8%	1.1
Portugal	-17.1%	-16.4%	0.7
Switzerland	-10.5%	-10.6%	-0.1
United Kingdom	-22.1%	-18.8%	3.4
United States	-10.2%	-10.4%	-0.2
Spain	-22.7%	-23.1%	-0.4

Source: ING calculations

The upshot is that with the end of the confinement and public services gradually returning to normal, the effect will be reversed and their GDP will be boosted by strong real growth in public consumption in 2H20. France could therefore see its GDP boosted by 3.2ppt in the second part of the year, while the boost will be 3.4ppt for the United Kingdom and 0.7ppt for Portugal. Belgium and the Netherlands could also see their GDP topped up by an increase in public spending as non-emergency medical treatment resumes at a similar pace to that before the crisis. Two of the other laggards, namely Italy and Spain, won't get this relief in terms of growth figures. This is especially true for Spain, which has been hit by another breakout of Covid-19 infections and has therefore suffered from a very bad tourist season, putting the country at risk of being one of the worst performing economies in the second half of the year.

Authors

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.