

In case you missed it: Two tribes go to war

For Donald Trump and Boris Johnson, it was a week to forget. An impeachment inquiry into Trump's call with the president of Ukraine and a rebuke from the UK Supreme Court over Johnson's decision to prorogue parliament dominated headlines and steered trading on both sides of the Atlantic. Here's what we think will happen next and what it means for the economy

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US politics: Trump weathers the storms

As Donald Trump faces the biggest test of his presidency so far, we take a fresh look at the chances of his re-election in 2020. In this latest update to our in-depth report, US Politics Watch: Four Scenarios for 2020 and Beyond, we have again teamed up with Oxford Analytica to examine how the race for the White House could play out



Source: ING, Oxford Analytica

A series of shocks over the summer leave President Trump and the Republicans lagging in the polls. Even with the Democrats moving towards impeachment, most experts still generally believe that the election is Trump's to lose.

It is still far from clear who Trump's opponent will be. The summer failed to deliver a knockout blow

to any of the key Democrat contenders, but that could soon change as the electorate assesses their responses to heightened geo-political tensions, rising economic uncertainty and controversial domestic policy debates.

Where things stand

House Democrats have called for President Trump to be impeached following reports that he withheld state aid to Ukraine before calling on Ukrainian President Volodymyr Zelensky to investigate the son of former Vice President Joe Biden.

However, the odds of Trump being removed from office (20 Republican Senator votes would be needed), or voluntarily leaving, are extremely low. President Trump thus remains set to be the Republican nominee in 2020, with his ability to win re-election reliant on a positive economy and the creation of any trade or foreign policy successes. After all, the latest developments make it even less likely there will be any bipartisan agreements in areas such as gun reform or infrastructure spending.

Other developments since our July update have offered both pluses and minuses for Donald Trump in his quest for re-election. In terms of foreign policy, the ongoing dispute with North Korea remains unresolved while tensions with Iran have been heightened following the imposition of additional sanctions after explosions at Saudi ARAMCO facilities in mid-September. The trade conflict with China has also seen little progress in terms of de-escalation, with the US imposing \$125 billion in new tariffs on 1 September. New talks are due in October but there is little optimism that a formal “deal” will be agreed.

Despite these challenges, the US economy remains relatively strong. There are clearly headwinds from weaker global growth and worries about geo-political tensions, but the domestic economy is robust for now and wages are rising. Equity markets have regained nearly all of their August losses and with mortgage rates hitting new cycle lows, households are confident in the outlook and willing to spend. It is a different story in the manufacturing heartlands with the ongoing threat that weakness here spreads more broadly within the economy.

'Experts' versus the polls

Despite polling in the low 40s and facing impeachment, many experts continue to predict a Trump victory in November 2020, creating a disconnect between current public sentiment, which seems to point towards a Democratic victory, and expert predictions. Several factors explain this, including the perceived value by analysts of a strong economy in a presidential election, and some overcompensation by analysts for misjudging the 2016 election.

Incumbent presidents are generally favored to win re-election, particularly when the economy is performing well; no incumbent has lost re-election during periods of economic growth in the last 40 years. As the US economy has continued to grow during Trump's presidency, many analysts are factoring in that performance when predicting his re-election, although they may be overestimating the importance of this, or discounting the potential that the economy will slow.

President Trump's polling numbers also do not take into account his challenger's level of popularity. Support for President Trump could rise or fall depending on the Democratic nominee and the press this person receives. We also have to consider that some of the

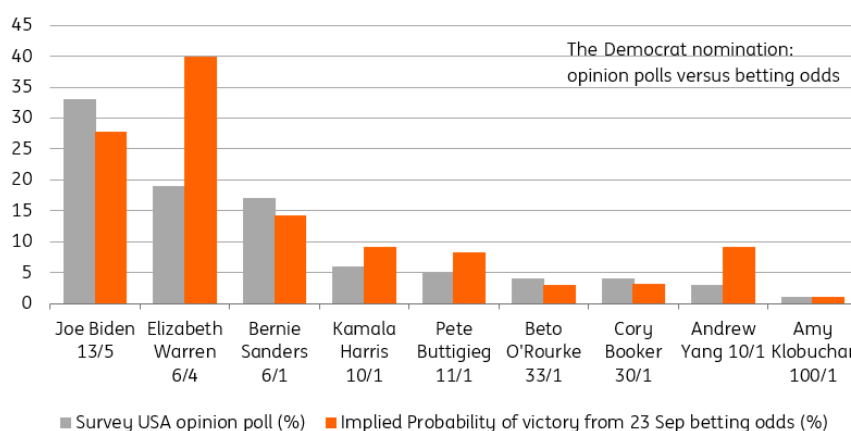
electorate may regard the impeachment push as a partisan attack. This could mean the Democrats actually lose some support in key swing districts while solidifying support for President Trump and boosting his campaign funding.

After incorrectly predicting his defeat in 2016, many experts are now also potentially overestimating his strengths, hoping to avoid the same mistakes made during the previous election. While hard to measure, this inherent bias against underestimating President Trump is adding to the general favored position he already occupies as the incumbent.

The Democrat race – back to where we started

While some issues- primarily enhanced national gun control legislation- have garnered support from across the spectrum, the key issues of the primary have yet to be decided; the debate between favoring electability and progressive policy priorities continues to split primary voters.

For the Democratic primary candidates, the summer has seen some significant ups and downs. Vice President Biden and Senators Bernie Sanders and Elizabeth Warren appear to be strengthening their grip on the contest following the third primary debate on 12 September. The surge Senator Kamala Harris experienced in July was short-lived, with her numbers returning to the figures prior to the first Democratic debate. It is yet to be seen how impeachment proceedings against President Trump impact this dynamic.



Source: Paddy power, ING, FiveThirtyEight

The movement in the betting market has been more marked with odds suggesting it is very much a three-horse race. The latest pricing implies a 40% chance of victory for Warren versus 22% in July. Biden's implied probability of victory has risen from 16% to 27%, while Bernie Sanders remains around 14%. Andrew Yang is still getting some backing, presumably reflecting expectations that his strong online presence can somehow turn around low name recognition scores. The betting odds of victory for Harris, like her polling, have plummeted. They stand at below 10% today versus 33% in July.

September 2019 Scenario Updates

With 13 months to go until the Presidential election, three possible scenarios are most likely: a Trump re-election, the election of a centrist Democrat, and the election of a populist Democrat. The foundational report published by [ING and Oxford Analytica in April 2019](#) also discussed a fourth scenario, that of another Republican winning the election. However, while such an outcome is not yet completely ruled out, particularly if impeachment proceedings sway moderate Republican Senators, the likelihood of this scenario occurring is too small to warrant an update.

Scenario 2 – a non-Trump Republican suddenly in the spotlight, but still unlikely

Impeachment proceedings against President Trump might, in theory, raise the odds of another Republican challenger winning the 2020 primary race- and the subsequent Presidential election. But in reality, this is unlikely to be the case.

With a two-thirds majority in the Senate required for President Trump to be removed from office, the chances of this happening are low. No Republican Senator has yet expressed support for such action and 20 Republican votes would be needed. Only clear evidence of wrongdoing which significantly sways public opinion is likely to change the vote in the Senate.

Senators would need to be convinced that Trump has less chance of winning re-election than President Pence. Given that the odds of being removed from office are slim, it is also unlikely that President Trump would resign or withdraw from the race. As he has yet to face a serious primary challenge, and the Republican National Committee has sought to limit the ability for him to be challenged, it is similarly unlikely that he would be defeated in a primary contest.

Barring a significant turn of events, this means that President Trump will, in all likelihood, be the Republican nominee in 2020.

Taking into account the lack of progress on trade and domestic politics over the summer months, the start of impeachment proceedings, and the drivers of the different election outcomes outlined in our foundational report, the following descriptions seek to show a narrative of how different scenarios may play out in practice.

Scenario 1 – Looking back from January 2021: How Donald Trump was re-elected

Concern about a slowdown in the economy and the refusal of the Federal Reserve to cut interest rates aggressively see President Trump place greater emphasis on securing a trade deal with Beijing during the first half of 2020. He also seeks to pass popular pieces of domestic legislation, such as infrastructure spending, to satisfy moderate voters. Still, given the tensions in Washington following the launch of impeachment proceedings, his efforts fail. Moreover, the move backfires on Democrats with many swing voters viewing impeachment as a partisan attack, which

has also helped to boost campaign funding and support for Donald Trump.

The US-China trade deal, agreed during the spring, leads to an immediate rebound in business and financial market sentiment with stock prices bouncing on the back of it. The White House uses this as a measure of the President's deal making skills – skills that he will use to extract concessions from other trade partners in a second term. Meanwhile, surprisingly successful cross-party legislation on gun control allows President Trump to tout some bi-partisan domestic policy achievements during the early stages of the Democratic Party primary.

With the economy experiencing modest growth during the early primary contests, Democratic voters remain divided over whether to prioritize electability or progressive policy ideals. The primary therefore becomes a long and drawn out contest that ultimately turns negative, with the vote split between four or five candidates past Super Tuesday. A nominee is not chosen until the party convention in July.

The end of a protracted Democratic primary in the summer of 2020 coincides with a strong uptick in US economic performance stemming from the trade deal concluded in the first quarter of 2020. This allows the White House to set the narrative of the general election around President Trump's leadership of the economy and the ultimate success of his trade policy.

Strong economic performance in swing states such as Ohio and Pennsylvania leading up to November 2020 allows President Trump to then expand upon his electoral map from 2016 and win a second term.

Scenario 3 – Looking back from January 2021: How a centrist Democrat was elected

With little progress having been made in the trade dispute with China at the start of 2020, and impeachment proceedings drawing significant public attention, President Trump's behavior and his trade policy are at the center of national politics. Responding to this, the Democratic party primaries and caucuses become overt contests over electability, supplanting policy as the main driver of primary votes. This allows a centrist Democrat to consolidate their position, based upon their perceived ability to attract votes in swing states away from President Trump, and emerge from Super Tuesday as the clear front runner for the nomination.

As the economy slides towards recession in the first half of 2020 and the government's policy comes under increased scrutiny, President Trump is forced to end the trade conflict with minimal gains. While hoping this would alleviate concerns over his handling of trade and allow the economy to rebound prior to the election, the narrative instead focuses on the relatively modest gains made compared to those promised, making his leadership style and poor relationships abroad key issues in the general election campaign.

As concerns over the direction of trade and foreign policy persist, and public approval over congressional handling of impeachment proceedings worsens, the number of moderate Republicans retiring from Congress steadily grows during the first half of 2020. They are replaced by candidates more closely aligned with President Trump, alienating some moderate suburban Republican voters, who are also increasingly concerned with the information presented during the impeachment inquiry.

In the run up to November 2020, the centrist Democratic candidate is able to consolidate these

voters and frame the election as a national 'reset' away from President Trump's bombastic style. This allows the centrist Democrat to carry key states Trump won in 2016 and the election.

Scenario 4 – Looking back from January 2021: How a populist Democrat was elected

2019 ends with intensified sanctions against the Chinese economy, as trade talks break down once more. As the economy heads towards a recession, President Trump remains committed to the conflict, blaming poor economic performance on the intractability of the Federal Reserve to aggressively cut interest rates.

President Trump is unable to pass significant legislation during the first half of 2020, with Democrats in the House denying him any political gains prior to the election. Impeachment proceedings past the first quarter 2020 see the White House end negotiations with the Democratic leadership on numerous pieces of legislation.

Senator Mitch McConnell delays the Senate hearing of the House's articles of impeachment, stymying the process and further enflaming public opinion. Many consider this unconstitutional, giving greater strength to Democratic candidates who argue that structural change is needed. Support for impeachment rises above 55%.

With the economy faltering prior to the Iowa Caucus in February 2020, populist Democratic candidates seize upon the growing public concern to promote increasingly progressive policies on welfare, education, taxation and healthcare. Forcing the primary to the left before Super Tuesday, the main populist candidates become the frontrunners for the Democratic nomination, with the post Super Tuesday contests decided between them.

As the second half of 2020 begins, the trade conflict with China remains unsolved, while the new European Commission has pursued increased fines for American technology firms and implemented sanctions as a result of its case against Boeing at the World Trade Organization. Doubling down on his approach, President Trump pushes through strong economic reprisals, further worsening the overall economic outlook prior to the election.

Increased public concern over the economy creates support during the early fall for flagship populist policies such as Medicare for All, cancelling student debt and free public universities. Forced to campaign against these positions, President Trump is unable to repeat his electoral success in the Midwest and loses by large margins in major urban areas, allowing the populist Democratic candidate to win the election.

The economic implications

The scenarios are driven by very different economic and political factors and will yield different outcomes for the US and global economies. For example, under scenario 1, President Trump may find that his domestic legislative agenda is curtailed by opposition lawmakers if Democrats retain control of the House. This could see him re-focus his attention back to trade where he has more leeway. In an environment of ongoing weak global growth, renewed tensions could see market and economic sentiment come under downward pressure once again, exacerbating the risks for the US economy.

Conversely, while the centrist Democrat scenario stems from economic weakness, tax cuts

and increases in infrastructure spending could be pushed through (if Democrats retain control of the House), which could provide a boost to growth in 2012/2022. Moreover, better relations with trade partners or a more conciliatory tone towards Europe with the aim of extracting concessions from China could be helpful.

A clean sweep for the Democrats under a populist president could see a more substantial fiscal stimulus package that delivers a sharp rebound in growth. However, lingering concerns about higher corporate taxes and greater regulatory oversight, particularly for Big Tech, could limit the upside for equities and the dollar. Moreover, it is possible that a Populist Democrat picks up where Donald Trump left off regarding aggressive trade protectionism, leading to renewed geopolitical and economic tensions.

These scenarios highlight the high stakes involved in the 2020 elections. There is plenty of time for surprises along the way and we will continue to watch developments closely and update our views accordingly.

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No Brexit deal in sight and UK election still highly likely

As MPs return to Westminster, it's clear that the UK prime minister faces an uphill battle to get a Brexit deal approved before the 19 October deadline set by lawmakers. Failure would oblige Boris Johnson to ask for another Article 50 extension and that means an election later in 2019 still looks highly likely



The British Prime Minister, Boris Johnson, returns to the UK from New York after parliament was recalled

Johnson faces an uphill struggle to get a deal

It's been another remarkable couple of days in Westminster. The Supreme Court ruled that the UK prime minister's decision to suspend Parliament a couple of weeks ago was unlawful. The House of Commons has now reconvened.

But despite the fanfare, the implications for Brexit are less obvious. Remember, the main consequence of the suspension was that it made it harder for MPs to legislate against an October 'no-deal' exit. But despite these obstacles, MPs still succeeded in approving a law designed to force the prime minister to ask for a further Article 50 extension, should he fail to get a deal approved by Parliament by 19 October.

This deadline leaves the prime minister with just over three weeks to find such a deal, and with an

election potentially looming, there are incentives to get one. Securing approval for an agreement would avoid the potential political embarrassment of having to ask for another Brexit delay. It might also help stem the tide of Conservative voters to the Brexit Party at the next election (assuming a deal, that enables the UK to leave the EU before voters go to the polls, is perceived as Brexit being "done").

UK's backstop proposals don't go far enough

But getting a deal over the line will undoubtedly be tough.

The UK government is seeking changes to the Irish backstop – the mechanism designed to avoid a hard border between Northern Ireland and the Republic of Ireland – but both sides remain poles apart. To recap, this backstop would keep Northern Ireland aligned to key single market rules, avoiding the need for goods to be checked against EU standards. The UK as a whole would also stay in a customs union – that helps avoid the paperwork and cost relating to tariffs and rules of origin.

So what is the government after instead? Well the UK has signalled that it would be prepared to allow Northern Ireland to maintain EU rules on certain agricultural exports. These farm and animal products tend to be among the most heavily scrutinised products at international borders.

The EU remains sceptical

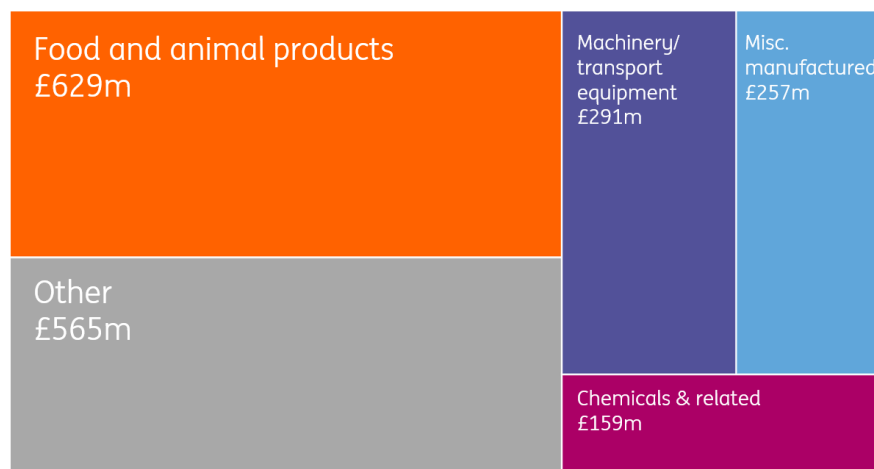
However food/animal products only make up around a third of Northern Irish exports to the Republic – there are large swathes of other goods that move across the border, and the UK is more reluctant to align with EU rules here. More importantly, the UK is deeply against allowing the UK, including Northern Ireland, to remain within the EU's customs regime – partly because this would make future non-EU trade deals less feasible.

Instead, the UK is proposing “alternative arrangements” – things like trusted-trade schemes and electronic pre-clearance for goods passing over the border – to keep trade moving.

However, the EU remains sceptical. A trusted-trader scheme – a certification system ensuring firms have adequate processes in place to comply with the rules – is only likely to be an effective solution if all exporters are, well, trusted. With differences in regulatory/customs regimes between the Republic of Ireland and Northern Ireland comes an increased incentive to smuggle.

Camera equipment and spot checks could help police this, although by definition this involves border infrastructure, something which many are wary could risk greater political tensions in the region. There is also the added logistical complexity that there are more than [200 crossing points](#) along the Irish border – including some roads that sweep multiple times across it.

Northern Ireland exports to Republic of Ireland by category (2016)



Source: ONS

If Johnson wants a deal, it might have to be 'off-the-shelf'

In other words, it seems unlikely that there will be a big breakthrough in talks over the backstop.

So if the government is set on bringing a deal back in October, then it might have to be something that closely resembles an 'off the shelf' option. One possible route might be the so-called Northern Ireland-only backstop. This was the EU's original proposal, and the key difference is that only Northern Ireland would stay in a customs union with the EU – not the UK as a whole as is the case in the current iteration of the backstop.

However, the UK government remains highly reluctant to permit any part of the UK to stay aligned with the EU on customs, even if it may ultimately accept a greater role for single market rules in Northern Ireland.

The numbers in Parliament still appear stacked against a deal

It's also not clear that such a manoeuvre would help Johnson politically. The Northern Irish Democratic Unionist Party are [reportedly](#) more open to a compromise than a few months back. But a deal of this kind would still involve barriers between Northern Ireland and the rest of the UK – a key DUP red line.

There has also been plenty of discussion about potential Labour MPs coming out in favour of the prime minister's deal – many [reportedly](#) regret not voting for Mrs May's deal a few months back. This group – perhaps around 30 in number – represent Leave-supporting seats and are perhaps wary about Labour's prospects in these areas at the next election.

But while they might be more open to a deal, it's not clear they'd vote for any deal. The final iteration of Mrs May's proposal more-or-less guaranteed a customs union with the EU, as well as certain provisions on workers' rights. A return to the so-called NI-only backstop could see both

aspects fall away.

What is the Northern Ireland-only backstop?



Source: ING

Article 50 extension and election remain highly likely

The upshot is that the numbers in Parliament still appear stacked against a deal - making it unlikely that the prime minister will be able to get one before the 19 October deadline.

Beyond then, the prime minister would be obliged to seek an Article 50 extension from the EU. And while there have been suggestions that the prime minister could ignore this obligation, the Supreme Court's unanimous verdict this week serves a reminder that the courts would probably quickly step in.

Our base case, therefore, remains that the UK is headed for a general election - the question remains 'when' and 'how'.

Opposition leader Jeremy Corbyn has indicated that he won't trigger a vote of no confidence in the government this week - and is unlikely to do so until an Article 50 extension has been secured. Assuming that a delay is secured some time in mid-October though, then an election could feasibly take place in early/mid-December. We'd assume there would be a desire to get it out of the way before Christmas in any case.

Don't be fooled - 'no deal' could still happen

Given the law surrounding an Article 50 extension, the perceived risk of a 'no deal' occurring on 31 October has fallen. It's worth noting though that, while much less likely, it is still possible.

Don't forget that the EU will need to agree to another Article 50 extension, although it currently looks unlikely that Brussels would reject such a request.

The risk of 'no deal' could come to the fore again after an election

There is also an apparent [loophole](#) in the law surrounding an Article 50 request. If PM Johnson gets approval for a deal from MPs before 19 October, then the obligation to ask for another delay falls away. But approval isn't the same as ratification, and the House of Commons will need to rapidly pass various pieces of legislation before the UK leaves the EU.

If this process falls apart - or the government fails to table this legislation at all - then worries about a 'no deal' exit on 31 October could feasibly resurface.

That said, this currently seems like a pretty unlikely turn of events - and we may even see opposition MPs step in again now Parliament has resumed to make the legislation surrounding an Article 50 extension more water-tight.

One final point - the risk of 'no deal' could come to the fore again after an election. If the Conservatives were to win a majority, as some polls currently suggest, then the feeling is that a 'no deal' scenario would become much more likely. However, it's worth noting that the result of an election is incredibly tough to call at the moment, given the volatility of UK politics.

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US & China trade: Who is “winning?”

US – China trade tensions are an obvious threat to supply chains and corporate profitability. Businesses are trying to adapt to the new environment with third party countries seemingly benefiting from the impasse at the expense of both China and the US



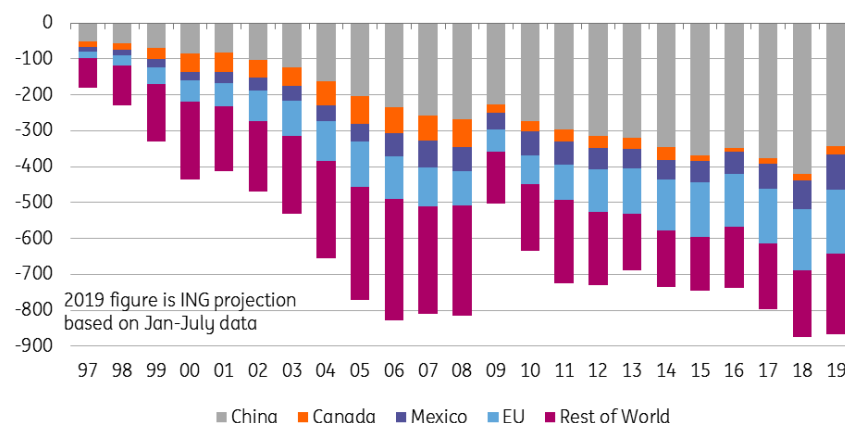
Source: Shutterstock

President Donald Trump shakes hands with Chinese President Xi Jinping during a meeting on the sidelines of the G-20 summit in Osaka, Japan

So far so good for the US?

One of President Trump's election campaign promises was to get better trade deals for the US. China has been the focus of his attention as he seeks improved access for America companies while protecting intellectual property rights. On the face of it the policy appears to have been a success for the US. The US goods deficit with China has shrunk 11% for January-July 2019 versus the same period in 2018. This means the US is on track to experience its smallest goods trade balance with China since 2012.

US goods trade balance breakdown (USD bn)



Source: Macrobond, ING

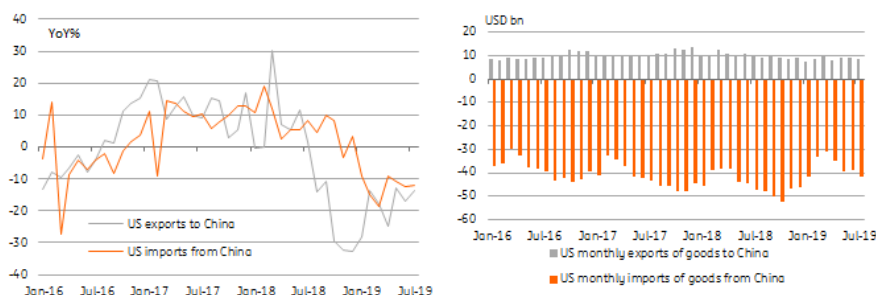
In reality both sides are losing...

However, the chart above shows that the US goods deficit overall is not narrowing to anywhere near the same extent. Instead, the US deficits with Mexico and the EU look likely to hit new highs in 2019 while the deficits with Canada and the “rest of the world” are on course to widen out versus 2018. This hints at some substitution of Chinese goods imports for imports from other countries.

President Trump has suggested that unless China agrees to US demands “China’s supply chain will crumble and businesses, jobs and money will be gone!” Unfortunately for the US, the charts below suggest that American companies are feeling pain too. There has been a reduction in goods imports from China, but there has been an even bigger percentage decline in US exports of goods to China (as measured in US dollars). This will be due in part to the tariffs China has placed on some US imports, but also the general slowing of the Chinese economy with possibly some currency effect too.

This may seem a confusing outcome given the narrowing of the trade deficit. It is because the value of US imports from China dwarf the value of US exports to China - the smaller percentage change still yields a much bigger dollar outcome. The net effect of the trade war is that both sides have been hurt.

US-China trade YoY% and monthly flows in USD bn

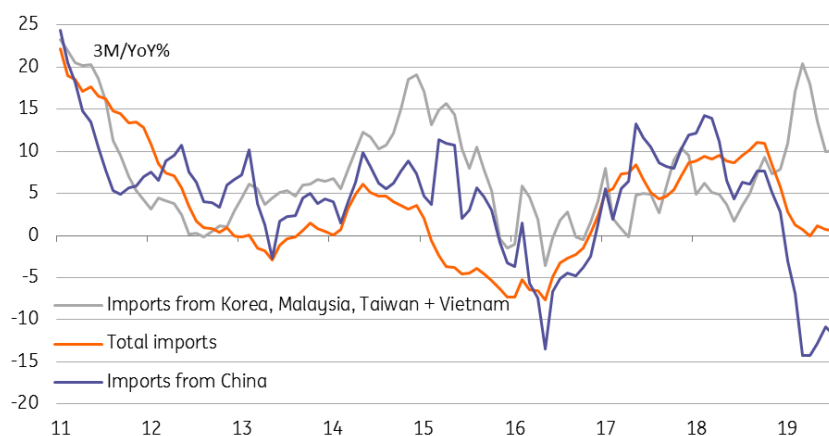


Source: Macrobond, ING

US businesses are looking for solutions

Given the scale of demand for Chinese intermediate goods within US supply chains there are clearly going to be challenges for US companies domestically too. Higher tariffs put up costs of Chinese products imported into the US, some of which is likely passed onto consumers, but the net overall result is still likely to be a hit to US corporate profitability. Businesses are looking for ways to limit the financial impact and this typically involves trying to find alternative suppliers, either [domestically](#) or from abroad. This takes time, but there is clear evidence that US firms have increasingly been sourcing alternatives from other Asian countries.

US import growth from China versus other Asia & World



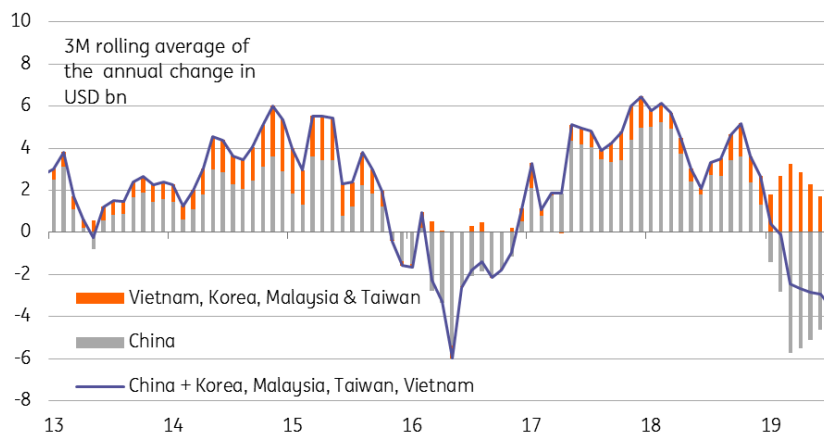
Source: Macrobond, ING

Looking for alternative supplies...

The chart above shows that US imports from Korea, Malaysia, Taiwan and Vietnam have accelerated sharply over the past year, which coincides with the steep drop in imports from China, supporting the substitution effect hypothesis.

We have to remember that the US historically has imported far more from China than other Asian countries so we need to also look at the 12M change in USD levels (chart below). The substitution effect since late 2018 is again clearly evident, but it shows us that the dollar value drop in imports from China has not been fully offset by higher dollar value imports from Korea, Malaysia Vietnam and Taiwan. Currency effects at the margin may have an influence, but only the Korean Won has underperformed CNY since 2018. We also have to consider that some of this slack may have been picked up by Mexico and the EU given expanding US deficits with those trade partners.

Change in USD value of imports into the US from China versus other Asia



Source: Macrobond, ING

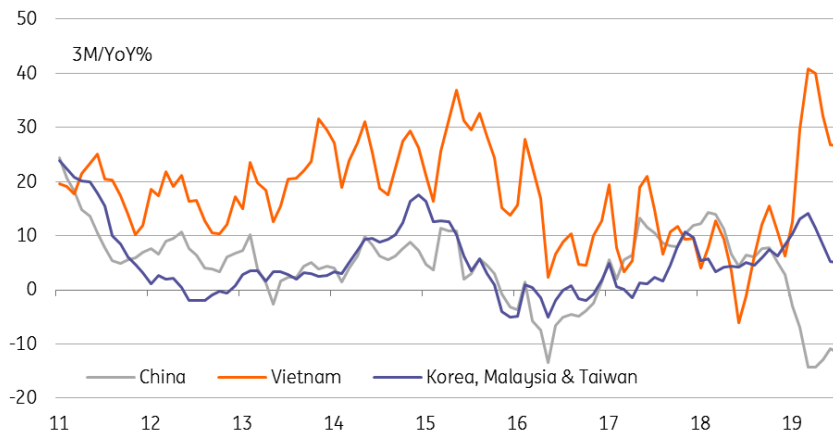
... or work-arounds...

Of course, it is possible that the economic pain China is feeling from the trade war has been mitigated by some businesses trying to “work around” the tariffs. This is typically done by exporting to an unsanctioned country where some “value added” is created before being shipped onto the final destination – thus avoiding the tariff.

This is a tried and tested formula with one of the more extreme examples being Russia. It takes time to find alternative suppliers from different countries or to develop domestic ones. When sanctions were first imposed on imports from the EU, Russia companies used business relationships to import EU products via 3rd party countries, including Belarus. This put up costs, but ensured supply chains could continue functioning until alternatives were found.

If that has indeed been happening as a result of the US-China stand-off, the most likely avenue is Vietnam. While US imports from Korea, Malaysia and Taiwan have certainly increased, it is from Vietnam that they have surged.

Growth in US imports from selected Asia countries - Vietnam the outperformer



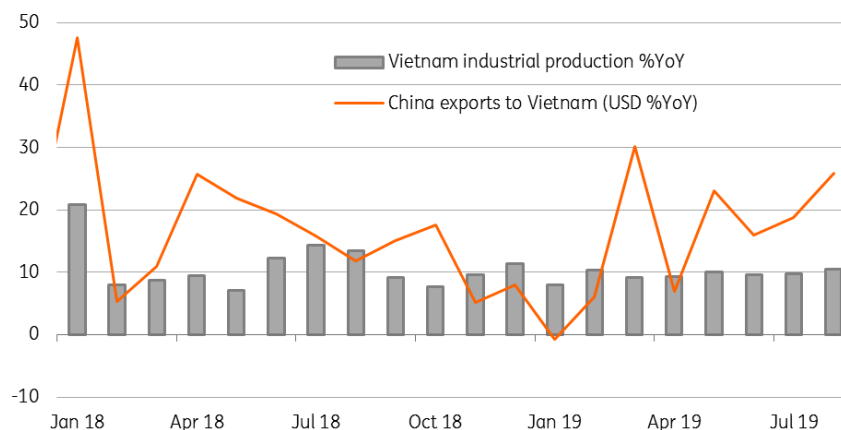
Source: Macrobond, ING

Chinese, but "made in Vietnam"?

It is difficult for an economy to build extra production capacity and related supply chains in a short period of time to substitute even part of the production from China. Vietnam's manufacturing production growth was quite flat at around 10% year-on-year in 2019. It was even slower in 2018. It is hard to believe that the surge in Vietnam's exports to the US (in US dollar terms, remember) has all come from production within Vietnam.

The obvious response is that it hasn't. Chinese exports to Vietnam have displayed a strong upward growth trend in 2019, which is in contrast to the slowdown in 2018, and also in contrast to the moderately flattish growth of Vietnam's production.

China exports to Vietnam growing much faster than Vietnamese manufacturing output



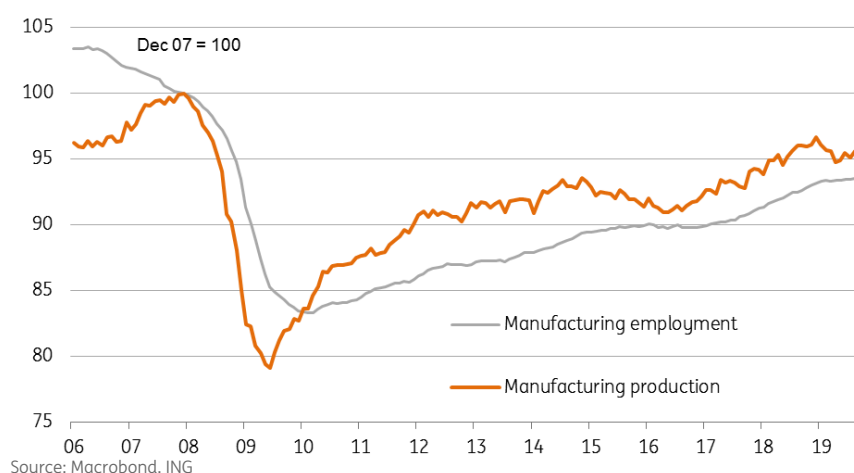
Source: Bloomberg, ING

FDI is starting to flow

But this kind of re-routing could be temporary as Chinese companies start shifting production lines to other economies given the fear that poor US-China trade relations and prolonged use of tariffs could be the new norm. For example, it has been widely [reported](#) that a Chinese manufacturer of bluetooth earphones plans to move production of Apple AirPods to Vietnam for an investment of US\$260 million.

The longer the trade disruption lasts more Chinese manufacturers will likely go down this route to tap the new opportunities. And, those emerging economies that receive these FDIs will benefit from the China-US trade war and could experience better economic growth.

Level of US manufacturing output and employment versus 2007 peak



US manufacturers still waiting for the boost

President Trump would ideally prefer US manufacturers to benefit, but with US manufacturing output down 1.1% year-to-date and 4.4% below the peak levels of December 2007, there is little evidence yet that domestic manufacturing is picking up the slack in any meaningful way. The caveat to this statement is that this is very much a headline figure and it is possible that some US manufacturers are receiving orders for some of what was serviced by Chinese imports at a time when demand for US manufactured goods is falling overall. This downturn in itself may be in large part caused by worries over the lingering effects of the trade war.

With durable goods orders pointing to a contraction in domestic capital expenditure in coming quarters and the manufacturing ISM in negative territory, there seems little prospect that we will see a near-term build-up in domestic US manufacturing potential. Maybe one solution to the impasse is if China was instead to move some of its production to the US, but this looks highly unlikely to happen in the near-term given the current political stand-off. Despite their respective claims, the US and China look set to both remain losers from the trade war.

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Snap | 25 September 2019

ECB: Unexpected shake-up

The German member of the ECB's Executive Board, Sabine Lautenschläger, just announced her resignation from office by the end of October



ECB headquarters, Frankfurt

This is another shake-up of the ECB. Sabine Lautenschläger has announced that she will resign from office by the end of October. Lautenschläger has been on the ECB's Executive Board since 27 January 2014, when she succeeded Jörg Asmussen, who back then left the ECB for a position in the German government. Her eight-year term would normally end in January 2022. Lautenschläger has been mainly responsible for setting up the Single Supervisory Mechanism (SSM). No reasons for her resignation were given in the press statement. So far, the motivation for her resignation is unclear. It may be due to personal reasons but perhaps also a protest against the ECB's recent decision to engage in another round of monetary easing. The latter would fit into an almost typical German tradition as previous Executive Board member Jürgen Stark and Bundesbank President Axel Weber both stepped down in protest.

Sabine Lautenschläger has been the most vocal and often the only member of the Executive Board to publicly criticise the ECB's bond purchases. Some commentators had also expected her to be in the race for chair of the SSM, which eventually went to the Italian Andrea Enria. Lautenschläger will now be the fifth Executive Board member to resign before the official term ends.

- The first ECB President Wim Duisenberg resigned in 2003 to make way for Jean-Claude Trichet
- Lorenzo Bini Smaghi resigned in 2011, leaving only one Italian national on the Board after Mario Draghi had become president.
- Jürgen Stark also stepped down in 2011 to demonstrate his opposition against possible bond purchases
- Jörg Asmussen stepped down in 2013 to take a job in the German government.

The resignation of Lautenschläger means that there will be two new Executive Board members this autumn, as Benoit Coeuré's term will finish at the end of the year. It is almost a given that Lautenschläger will be replaced by another German. Don't count on Jens Weidmann, who would have trouble advancing German interests anyway, as the most influential portfolio economics is controlled by Philip Lane. More likely candidates are Isabel Schnabel (member of the Council of Economic Advisers) or Claudia Buch (Vice-President of the Bundesbank). When it comes to the replacement of Coeuré, Eurogroup President Mario Centeno yesterday announced that there was only one official candidate for Coeuré's succession: the Italian Fabio Panetta, Vice-President of the Italian central bank. The official deadline set by the Eurogroup to bring candidates forward ended yesterday and it will be interesting to see whether any national government will change its mind after last night.

In any case, if Lautenschläger's resignation has really been driven by her opposition to the ECB's latest decision to cut rates further and to restart quantitative easing, it would worsen the divide between hawks and doves. While to some extent dissenting views can be seen as another step toward becoming a mature central bank, the fact that opposition to the last policy decision has become very vocal, even after the decision, shows how fragile the ECB currently is. When Christine Lagarde takes over from Mario Draghi in November, she will have her work cut out to mend ties.

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Russian de-dollarization: Banks on board, others need convincing

Over the last 5-6 years, Russia has made some progress in diversifying its trade flows and international liabilities away from the US dollar. We note, however, that USD is still quite popular as an asset for the private sector despite the persisting risks of US sanctions. This is relevant for companies and banks focused on doing multi-FX business in Russia



Source: istock

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A \$20 billion tax boost to corporate India

Whether this helps to kick-start the economy is still to be seen. For now, the negative consequences of derailed fiscal consolidation on India's external creditworthiness keeps a weakening pressure on local financial assets. We retain our end-2019 USD/INR forecast at 73.50



3.9%

ING's fiscal deficit forecast for FY2020

Revised up from 3.5%

Unexpectedly big tax boost

In a surprise move last Friday, Finance Minister, Nirmala Sitharaman, announced a significant tax reduction for domestic companies. The move is estimated to cost about \$20 billion to the government in lost revenue, includes a cut in the corporate tax rate to 22% from 30%, taking effect retrospectively from 1 April 2019, the start of the current financial year. This takes the effective tax rate after all additional levies to 25.2% from 25.9%.

In more incentives for new start-ups, for companies to be incorporated from 1 October 2019, the tax rate is set at 15%, down sharply from the existing 25%. Furthermore, reversing some of the tightening measures announced in this year's budget, the government rolled back surcharges

introduced on capital gains from the sale of securities, including derivatives, and exempted companies from share buyback taxes for buybacks before July this year. Also announced on Friday was a reduction in the Goods and Services Tax (GST) for some sectors.

Incessant stimulus

The latest round of fiscal boosts followed a slew of measures announced over the last month.

- **23 August:** Withdrawal of surcharge on long and short-term capital gains tax on foreign portfolio and domestic investors; \$9.8 billion (INR 700 billion) capital injection for public sector banks; lifting of curbs on new vehicle purchases by government departments.
- **29 August:** Easing of foreign investment regulation for retail, manufacturing and coal mining sectors. Relaxing local sourcing norms for foreign companies selling their own brand in India. Removal of caps on investment in commercial coal mining. Up to 26% investment permitted in digital media.
- **30 August:** Consolidating 10 public sector banks into four - A) Punjab National Bank, Oriental Bank of Commerce, and United Bank; B) Canara Bank and Syndicate Bank; C) Union Bank of India, Andhra Bank and Corporation Bank; and D) Allahabad Bank and Indian Bank.
- **14 September:** \$7 billion tax incentive for exporters. Measures to boost the real estate sector.
- **20 September:** \$20 billion corporate tax reduction for domestic companies (details as described at the onset). Reduction of GST on hotel rooms (18% from 28%) and catering services (5% from 18%), but a hike in that on caffeinated beverages (40% from 28%).

Near-term pain, long-term gain

The reduction in tax rate puts corporate India on par with Asian neighbours (standard rate of about 25% in most Asian countries, 17% in Singapore and Hong Kong), which is significantly positive for the economy over a longer-term.

Indeed, the latest measures should do what they are intended to – revive growth. But how quickly and effectively this will happen in the current climate of strong external risk remains to be seen. There is little that fiscal policy can do to overcome external hurdles to growth, in particular, the recent spike in global oil prices. With 80% of its energy requirement imported, India will have difficulty in keeping the oil price spike from affecting domestic fuel prices and overall inflation. On the domestic front, the still high level of personal income taxes of more than 30% and a decade-high unemployment rate are sapping the vigour of consumer spending – the key driver of GDP growth.

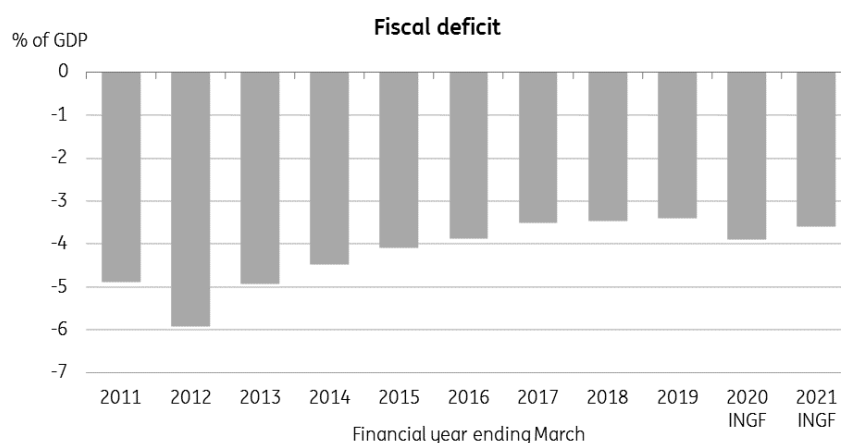
Where is the fiscal deficit headed?

Moreover, the aggressive stimulus adds to the economy's long-term plight by further delaying fiscal consolidation. Certainly, the immediate implication will be a blowout of the fiscal deficit well above the government's 3.3% of GDP projection for the current fiscal year.

The \$20 billion worth of revenue loss from corporate tax measures (leaving aside other stimulus efforts announced over last one month) itself amounts to 0.7% of GDP, which on its own will swell the deficit to 4% of GDP. While some of this revenue loss will be shared by state governments and the central government may count on improved tax compliance due to lower rates as an offset, an additional whammy from slower GDP growth depressing revenue cannot be ruled out.

We are revising our deficit forecast for the current fiscal year from 3.5% to 3.9%, wiping out nearly all the deficit reduction over the last three years.

Derailed fiscal consolidation



Source: CEIC, ING

What about financing?

There is no clarity about how the government will be financing this wider deficit. The \$24 billion payouts from the RBI's coffer won't be enough, nor can the government continue to rely on such monetization of the deficit.

The prospect of turning to global debt markets for financing remains clouded amid the prevailing uncertain market environment, more so now as the global investors will, in all likelihood, be viewing excessive fiscal loosening negatively. S&P has left no time in warning of the negative implications of recent fiscal actions. This is a further blow to the government's plan to borrow overseas, which, in turn, means a greater strain on domestic debt markets where excessive government borrowing leads to crowding out of private investment demand – a recipe for continued sluggish GDP growth ahead. A vicious cycle could go on.

And RBI is ready to do more

The Reserve Bank of India's (RBI) aggressive monetary easing with a total 110 basis point (bp) policy rate cuts implemented in four policy meetings so far this year has failed to arrest the growth slowdown. Last week Governor Shaktikanta Das assured markets of continued monetary stimulus for the economy through more policy interest rate cuts ahead. This makes another 25bp rate cut at the next bi-monthly policy review in early October almost certain. And there could be even more with our forecast of a further 25bp of cuts in December.

We identified growth as our highest priority in August. We have also maintained that it cannot be business usual now and the economy needs something more. Therefore, we went for 35 basis points cut in August. - RBI Governor Shaktikanta Das.

All this is potentially inflationary. But nothing matters beyond growth, at least while inflation is running below the RBI's 4% target.

Bottom line

Whether this helps to kick-start the economy is still to be seen. For now, the negative consequences of derailed fiscal consolidation on India's external creditworthiness keeps up weakening pressure on local financial assets. While more RBI easing is positive for the bond market, the negative from the supply overhang from a wider fiscal deficit is likely to outweigh this, and bond yields will remain under continued upward pressure. Last Friday's market reaction with a strong rally in the stocks but a huge selloff of government bonds speaks for itself.

The INR did gain some ground amidst the positive swing in sentiment towards the equity market, though we don't think this will persist given that currency will likely be undermined by weakening public finances, the renewed threat of higher oil prices leading to higher domestic inflation, and the persistently wide current account deficit.

We retain our end-2019 USD/INR forecast at 73.50 (spot 70.95).

India: Key economic indicators and ING forecasts

India (FY ending March)	FY2016	FY2017	FY2018	FY2019	FY2020 f	FY2021 f
Real GDP (% YoY)	8.0	8.2	7.2	6.8	6.1	7.0
CPI (% YoY)	4.9	4.5	3.6	3.4	4.0	5.0
Fiscal balance (% of GDP)	-3.9	-3.5	-3.5	-3.4	-3.9	-3.6
Public debt (% of GDP)	69.9	69.0	69.8	72.5	73.0	72.0
Current account (% of GDP)	-1.1	-0.6	-1.8	-2.1	-2.5	-2.4
FX reserves (mth of imports)	10.2	10.6	10.2	8.7	7.8	7.2
External debt (% of GDP)	182.1	168.2	171.3	165.3	174.2	178.0
RBI repo rate (% eop)	6.75	6.25	6.00	6.25	4.90	5.15
3M T-bill rate (% eop)	7.27	5.82	6.09	6.14	5.10	5.50
10Y govt. bond yield (% eop)	7.47	6.68	7.40	7.35	7.10	7.30
INR per USD (eop)	66.33	64.84	65.18	69.16	73.80	69.80

Sources: Bloomberg, CEIC, ING forecasts

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Mark Cliffe: Prepare for a central bank digital currency

Central banks will be moving towards creating a digital currency in the next two to three years, according to ING's Chief Economist, Mark Cliffe



Mark Cliffe: Prepare for a central bank digital currency

[Watch video](#)

Rapid advances in distributed ledger technology have spurred debate about the possibilities, advantages and drawbacks of central bank digital currencies. The principal limits and trade-offs seem to stem from CBDC's economic, monetary and financial contexts, and depend on underlying policy and political preferences concerning privacy, data administration, market power, cybersecurity, and the division of labour between the public and private sectors.

All these issues were discussed at a joint event held by ING and the central bank thinktank, OMFIF. ING's Mark Cliffe gives us his thoughts as to when we might see a fully-fledged central bank digital currency in this, the first of a series of video reports.

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