MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Inequality As A Cause Of The "Populist International"

We have written several times about the rise of populism at global level, and its repercussion on the political, economic, and financial developments of the countries in which the populist phenomenon is strongest. We have also discussed the potential repercussions for the liberal order and its institutions, such as the European Union, that were created after Word War II as a response to the damage caused by the nationalistic and populist movements of the first half of the 20th century.

Plenty of studies have been published that discuss the origin of this new wave of populism. A useful taxonomy is one in which contemporary populists have been classified into three categories: those who reached power for cultural or "identity-related" reasons (e.g. Brexit); those who claim to be anti-establishment (e.g. Donald Trump), and finally, those who came to power as a result of a widespread socio-economic malaise (e.g. Five Star and Lega in Italy). In this column we want to focus on the underlying causes of the last of these three categories: *socio-economic populism*. At the core of any economic malaise there is under-development and lack of opportunity, especially in emerging markets. In developed economies, however, where per capita income is much higher, it is the uneven or unfair distribution of income and wealth that seems to be the driving force behind the rise of populist forces in recent years.

As discussed in our recent in-depth analysis, income and wealth inequality (or lack of "inclusion", to use the expression of the IMF/World Bank) is one of the main causes of subdued growth and historically low real interest rates. As the IMF said in its 2018 Annual Report, "reducing inequality can open doors to growth and stability." Yet by causing subdued and uneven growth, inequality is also a primary origin of protest movements that want to rectify this situation, which sometimes are or have been classified as "populist."

In our analysis we discuss how income inequality has been increasing since the 1970s, when the primary distribution of income began to become skewed more towards profits, interests and rents and less to labour. At the same time, the *neo-liberist* revolution of Ronald Reagan and Margaret Thatcher also made the redistribution of income via taxation and subsidies less effective, on the back of what was labelled as *trickle-down economics*. Many years of increased globalisation, with its inherently deflationary forces (including on wages), reduced labour share of income in the most advanced economies (and parallel increase in the profit and interest share of income), diminished power of trade unions, mass privatisation of public goods, and inability of taxation and subsidies to redistribute income in a fairer way, have led to the current situation. Workers in many countries feel deprived, and are therefore willing to give a chance to political leaders who claim to be on their side, however inconsistent with this claim those leaders' biographies might be.

The policy solution to this problem seems quite straightforward: a more active role of fiscal policy, to promote income redistribution, increased public expenditure in infrastructure and education, the provision of job opportunities to younger generations by the public and private sectors. Some of these solutions are becoming popular even among the US electorate, with the rise of political leaders such as Bernie Sanders and Alexandria Ocasio-Cortez, who are not afraid of being labelled "socialists," a description which just a few years ago would have killed any political career. Nevertheless these solutions are easier said than done. Once in power, even their proponents realise how difficult implementing such policies tends to be, given binding budget constraints.

Wealth inequality is even harder to assess than is income inequality, as it is often a legacy issue (as wealth is accumulated over generations), and as it is the result of the cumulative effect of income inequality over a long period of time. A group of economists has suggested the adoption of a "wealth tax" as a solution to this issue. This might well be a solution, but the political economy of adopting such a tax would be complicated, and so might ultimately prove to be counter-productive.

All this is to say that income and wealth inequality are here to stay for the time being, and will continue to feed populist movements around the globe. Policy solutions are available, but their implementation is complicated and sometimes politically toxic. This means that probably things will have to get worse before they can get better.

Our Recent Publications

- Scenario Analysis: Tensions Between Iran And US Likely To Continue, With Increasing Risk Of Escalation, *by Giorgio Cafiero, Nouriel Roubini and Brunello Rosa, 14 August 2019*
- Income and Wealth Inequality Continues to weigh on global growth, *by Francesca Panelli, 16 August 2019*
- **GEOPOLITICAL CORNER**: India Lights The Kashmiri Powder-Keg, *by John Hulsman, 13 August 2019.*

Looking Ahead

The Week Ahead: In The EZ Manufacturing Weakens And FED Soon To Announce Future Movements

In the *EZ*, manufacturing sector activity is expected to weaken (Markit Manuf. PMI Aug., *c:* 46.3; *p:* 46.5), led by a sluggish industrial activity in Germany (Markit Manuf. PMI, *c:* 43.0; *p:* 43.2); yet, PMI indicators in the services sector are likely to remain expansionary (*c:* 52.7; *p:* 53.2). Inflation is expected to slow (CPI Jul., *c:* 1.1% y-o-y; *p:* 1.3; Core CPI, *c:* 0.9% y-o-y; *p:* 1.1).

In the *US*, Chairman Powell will deliver a speech at the Fed's Jackson Hole symposium on Aug 23; the markets will focus on whether the Fed's is planning: *i)* a long-term cutting cycle, against a global recession; or *ii)* a few insurance cuts, against an economic downturn.

The Quarter Ahead: Geopolitical Tensions Will Remain High and Central Banks Are Ready to Ease Policy

In the *US*, President Trump announced the delay tariffs on Chinese imports *"until December to shield US consumers during the Christmas shopping season"*; however, some goods such as clothing, watches, and electronics will face levies of 10% starting September 1. Overall, 69% of Chinese consumer goods will be subject to tariffs by September 1, up from the current 29%. Although economic data indicate: *i)* resilience in manufacturing and services; and, *ii)* a pick-up in inflation - market expectations for "*one rate cut"* at the Fed's September meeting remain high, at 78.8% (*p:* 84.6), due to rising concerns over trade and weaker global conditions.

In the *UK*, PM Johnson will reiterate at the upcoming G7 summit in France that the British parliament "*will not, and cannot, cancel the referendum".*

In the *EZ*, to support the flagging EZ economy amid trade uncertainties, according Governing Council member Olli Rehn the ECB is *"preparing a 'very strong package' of stimulus measures that should exceed investors' expectations"*, to be announced at the September policy meeting.

In *China*, the PBoC is set to replace they key lending rate with a market-driven benchmark - aimed at lowering borrowing costs for companies that have faced: *i)* tighter access to credit; and *ii)* poor investor sentiment, caused by the ongoing trade war.

Last Week's Review

Real Economy: Weak Economic Data Point To A Global Downturn

In the US, retail sales rose unexpectedly in July (*a:* 0.7% m-o-m; *c:* 0.3; *p:* 0.3), indicating that personal consumption–about 70% of US GDP–remains strong. Inflation rose more than expected in July (CPI, *a:* 1.8% y-o-y; *c:* 1.7; *p:* 1.6; Core CPI, *a:* 2.2% y-o-y; *c:* 2.1; *p:* 2.1) as tariffs begin to impact prices.

In the EZ, growth stagnated (GDP Q2; *a:* 0.2% q-o-q; *c:* 0.2; *p:* 0.2), as: *i)* IP weakened more than expected (*a:* -2.6% y-o-y; *c:* -1.2; *p:* -0.8); and *ii)* Germany - the largest economy - contracted in Q2 (*a:* -0.1% q-o-q; *c:* -0.1; *p:* 0.4). Investor sentiment on Germany's economic outlook fell to the lowest since 2011 (ZEW economic sentiment survey, *a:* -43.6; *c:* -21.7; *p:* -20.3).

In Japan, manufacturing keeps contracting, albeit at a slower pace (IP Jun., *a:* -3.3% y-o-y; *c:* -3.6; *p:* -3.6).

In the UK, inflation accelerated faster-than-expected (CPI Jul., *a:* 2.1% y-o-y; *c:* 1.9; *p:* 2.0).

In China, economic activity continued to slow down, as in July: *i)* retail sales softened (*a:* 7.6% y-o-y; *c:* 8.6; *p:* 9.8); and, *ii)* industrial activity weakened (IP, *a:* 4.8% y-o-y; *c:* 5.8; *p:* 6.3).

In Turkey, industrial output fell for a 10-month running (IP Jun., *a:* -3.9% y-o-y; *c:* -1.0; *p:* -1.3).

In Argentina, Fitch downgraded the country's credit rating to CCC (*p:* B).

In Mexico, BdeM cut its interest rate (*a:* 8.00%; *c:* 8.25; *p:* 8.25).

Financial Markets: Risk-Off Sentiment Driven By Trade-Related Uncertainties And EM Volatility

Market drivers: indicators pointing to a global downturn and persistent trade uncertainties drove investors to safe-haven assets.

Stocks: w-o-w, global stocks fell (MSCI ACWI, -1.2%) driven by both the US (S&P500, -1.3% to 2,889) and EMs (MSCI EMs, -1.1% to 970). Volatility rose (VIX S&P 500, +4.4 points to 18.5, 52w avg.: 16.7; 10y avg.: 17.1).

***Bonds*:** w-o-w, global indices rose (BAML Global bond index, +0.9%). The 10y UST yield fell w-o-w by 19 bps, to 1.54%. In MENA, bond supply stands at USD 67.0bn y-t-d, compared to USD53.2bn in 2018.

***FX*:** the USD appreciated (DXY, +0.7%) against a basket of currencies. The EUR fell (EUR/USD, -1.0% to 1.109). EM FX fell (MSCI EMs, -0.3% at 1,607), bar the Chinese Renminbi (USD/CNY, +0.3% to 7.041). In Argentina, the incumbent President's defeat in the primary elections led to a Peso sell-off (USD/ARS, -17.5% to 52.834).

***Commodities*:** Oil prices rose (Brent, 0.2% to 68.6 USD/b). Gold rose (1.1% to 1,514 USD/Oz.).

Farah Aladsani *contributed to this Viewsletter.* *The picture in the front page comes from this website*

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*