



Happy reading

Trust and the success of populism

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Dear readers,

As you may remember from previous years, shortly before the holiday season, we try not to bother you with economic data and financial market views in our last Weekly of the year. Instead, we take advantage of the period in which trading slows to write about the literature that has influenced our thinking throughout the year and to reflect on topics that go beyond the weekly ups and downs in financial markets. One topic that I have been preoccupied with this year, is the role of trust in economics. Trust between business partners allows for easier contracts, which do not require every eventuality to be pre-negotiated.¹ Trust between different groups in a society increases their solidarity beyond the family or the broader tribe. Trust between countries allows for cooperative agreements that enhance the overall welfare of both countries.

Considering the importance of trust in a society, 2020 was a difficult year. And once lost, trust is difficult to regain.

Yet lately, trust in science, media and elections has been eroded by populists who sowed and exploited doubts whenever facts did not match their own reality. This matters, as trust is the basis for the confidence in reliable future relationships on which capitalism and often also peace relies.

Social trust and successful cooperation are mutually reinforcing and lead to a better functioning of institutions.

There is ample empirical evidence why trust matters in practice. The one I found most interesting is a, by now, classic book by Robert Putman² who analyzed why northern Italy is doing so much better economically than the south, even though both parts of the country share the same institutions, the same currency, and the same political system. Those are usually determinants that should contribute to the convergence between the two regions as common institutions provide the same incentives for the accumulation of labor, capital and human capital on which long term growth relies.³

With the different development of Italian regions in mind, Putman went a step further and asked under which conditions institutions perform well.

Putman found that civic traditions and social engagement, characteristics which go back many centuries when a powerful monarchy ruled in Italy's south while communal republics were developed in the center and north, are the main factors explaining divergences in development among regions. In Italian provinces which do better, people tend to have more horizontal linkages between each other. These are relationships at a similar hierarchical level and can be any kind of network, including memberships in guilds, cooperatives, unions, mutual aid societies or even sport clubs. A vibrant civic community improves trust between members of a society, far beyond the immediate family. In this kind of environment, norms of reciprocity and civic engagement prevail. If people experience solidarity, they are more likely

¹ See D'Acunto, Francesco; Xie, Jin and Yao, Jiaquan: Trust and Contracts: Empirical Evidence, CESifo Working Paper No. 8714, November 2020.
https://www.cesifo.org/DocDL/cesifo1_wp8714.pdf

² Putman, Robert: Making Democracy Work – Civic Traditions in Modern Italy, Princeton University Press, 1993.

³ The role of institutions is best summarized by Acemoglu and Robinson (Why nations fail. Profile Books, 2013, p. 372): «*Nations fail today because their extractive economic institutions do not create the incentives needed for people to save, invest and innovate. Extractive political institutions support these economic institutions by cementing the power of those who benefit from the extraction.*»



If vertical relationships dominate in a society, cooperation among equals is less beneficial and trust is less developed or experienced.

The topic remains obviously important for today's EU policies

Trust implies that not everyone maximizes its interest all the time.

The important lesson of the prisoners' dilemma is that incentives for non-cooperation dominate independently of the other prisoner's willingness to cooperate or not.

Populists polarize intentionally

to show solidarity too and are less likely to engage in corrupt, exploitative and extractive behavior, which often weighs on the efficiency and efficacy of public institutions.

In contrast, regions where vertical linkages prevail do less well. Those are typically for monarchies with hierarchical patron-client relationships whose shape subordinates usually have little influence on. A larger distance to power means that the people do not own the system and do not trust the elites. Instead of trying to improve the rules of the system, individuals just try to avoid them. The level of tax compliance and the importance of the shadow economy are just two of many examples. Paradoxically, lower compliance makes stricter laws, tougher policies and authoritarian leadership more likely.

EU structural funds and the newly created EU Recovery Fund intend to level income disparities and to foster cohesion between regions. But all those means and a functioning institutional set up in the EU might just not be enough if there is a lack of trust within a society and towards EU institutions and rules.

If trust is so important – why then, you may wonder – wouldn't policy makers do their utmost to foster it? The answer is, because it comes with short-term disincentives. This can best be explained with the so-called "prisoners' dilemma". For the non-economists among the readers, I quickly summarize here the gist of it: *Two prisoners that are interrogated and isolated from each other have the choice to confess a common crime or to deny it. If they both deny it they are sentenced to say 5 months in prison for some petty offense. If they both confess, they receive a sentence of 2 years each. But if one denies and the other confesses than the one that confesses would benefit from a leniency program as chief witness and is getting free while the one that denies is sentenced to 5 years in prison. Both will know that they could minimize their combined sentence by denying the crime. But the dilemma they face is that they don't know whether they can trust the other to deny as each one would be even better off confessing independently of the other's choice.*

In the prisoner's dilemma non-cooperation is a stable, but inferior equilibrium. This holds if both prisoners know that they won't meet again. Prisoners learn the value of cooperation only if they are in a similar situation repeatedly and learn that trust in each other's cooperation has a value. This may explain the success of my-nation-first policies many populists propagate. Obviously, also no other policy maker would pursue policies that are mainly in the interest of another nation. However, populists and, in particular nationalists, highlight the benefits of a non-cooperative solution – hence, coming back to the example of the prisoner's dilemma, their behavior is equivalent to a confession, even in repeated situations, as it maximizes their short-term benefits. Starting from a trust-based relationship with another country, potentially based on a long history of co-operation, they may reap additional benefits. In the prisoners' dilemma, that's equivalent to a situation in which a my-nation-first policy maker confesses while another nation's leader does not, as he or she relies on the long history of cooperation. This might explain why some populists seem to treat their (cooperating) allies worse than their (so far non-cooperating) foes. And it might explain why they use the threat of non-cooperative behavior to bully their partners into new agreements that re-distribute the gains of co-operative behavior in their own favor.

Populists often justify their non-cooperative and norm-busting behavior by denying the common ground with those they cease to cooperate with. Hence, blaming minorities, foreigners or others than their own tribe serves not only the purpose of fostering the common ground among their supporters, it also provides the moral justification for non-cooperative behavior.



Populist policies seem appealing, as they have short-term benefits while their long-term consequences are neglected.

Populist economic policies often try to maximize short-term nominal GDP growth by accepting higher budget deficits, debt, and inflation in the medium term – side effects they do not mind, as it will likely be future administration that has to bring them back down, while they can reap the short-term gains. They dismiss the need for environmental or other regulations – and some even deny climate change for that reason – as these often have political implications that may hurt economic output over the short term. Similarly, it is striking that populists all around the globe have shown a tendency to play down COVID-19. They have tried to avoid general restrictions as, by definition, they care less about minorities who do not form major voting blocs, but who have been suffering disproportionately from COVID-19. Trust pays dividends until it is lost. The electorate loses trust in populists when the long-term costs of their policies become apparent. For that reason, populists often double down on their policies, which then can end in debt-defaults, hyper-inflation or even war. It might, therefore, also be no coincidence that populists often turn increasingly autocratic over time.

A high debt level can be sustained if creditors trust the solvency of a debtor. But it can become unsustainable if creditors raise doubts and demand higher interest rates.

Once lost, trust is difficult to regain. This is particularly relevant in financial markets where multiple equilibria are possible. It was the signalling effect of the EU Recovery Fund that has restored trust in the sustainability of peripheral countries' debt. It is the trust in central banks to provide price stability which is preventing wage-price spirals. It is the trust in the liquidity and the safety of the US dollar that justifies its status as the main global reserve currency and has allowed the cheap financing of the huge US current account deficit. However, the more often the US exploits the trust in the dollar, using it to enforce their interests via the international payments system by imposing fines on countries that do not comply with US sanctions, the more pressure they add on others to find another reserve currency.

People will get their injections only if they trust the institutions which have approved the different vaccines.

Trust will play a major role when COVID vaccines are rolled out. I expect to see higher vaccination rates and a shorter time to achieve herd immunity in countries in which trust into the government or the neighbours is relatively high. It will likely be those countries in which horizontal social linkages and civic engagement are more prevalent than in others.

**I would like to thank you for your trust and interest throughout this turbulent year!
We will be back with new economic comments on January 8th.
In the meantime, stay safe and healthy and enjoy a nice holiday period!**



Source: iStock



Economic Calendar

Week of 21/12 – 25/12/2020

Country	Time	Item	Date	Unit	Consensus	
					Forecast	Prev.
Monday, 21.12.2020						
US	14:30	Chicago Fed Nat Activity Index	Nov	Index	--	0.83
Tuesday, 22.12.2020						
UK	08:00	GDP QoQ	3Q F	qoq	--	15.50%
	08:00	GDP YoY	3Q F	yoy	--	-9.60%
US	14:30	GDP Annualized QoQ	3Q T	qoq	33.10%	33.20%
	14:30	Core PCE QoQ	3Q T	qoq	--	3.50%
	16:00	Conference Board Expectations	Dec	Index	--	89.50
	16:00	Existing Home Sales	Dec	mn	6.65	6.85
	16:00	Richmond Manufact. Index	Dec	Index	--	15.00
Wednesday, 23.12.2020						
US	14:30	Cap Good Orders Nondef Ex Air	Dec	mom	--	0.80%
	14:30	PCE Core Deflator MoM	Dec	mom	0.10%	0.00%
	14:30	PCE Core Deflator YoY	Dec	yoy	1.40%	1.40%
	16:00	U. of Mich Sentiment	Dec F	Index	81.00	81.40
	16:00	U. of Mich Expectations	Dec F	Index	--	74.70
US	16:00	New Home Sales	Nov	1'000	990k	999k
Thursday, 24.12.2020						
No economic data						
Friday, 25.12.2020						
JN	00:30	Tokyo CPI YoY	Dec	yoy	-0.90%	-0.70%
	00:30	Tokyo CPI Ex-Food, Energy YoY	Dec	yoy	-0.30%	-0.20%
	00:50	Retail Sales MoM	Nov	mom	-0.90%	0.40%
	00:50	Retail Sales YoY	Nov	yoy	1.70%	6.40%

Source: Bloomberg, J. Safra Sarasin as of 17.12.2020



Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.56	1	-9	0.6
German Bund 10 year (%)	-0.58	2	-40	2.7
UK Gilt 10 year (%)	0.27	7	-60	4.6
US Treasury 10 year (%)	0.92	1	-96	9.8
French OAT - Bund, spread (bp)	24	-1	-7	
Italian BTP - Bund, spread (bp)	111	-6	-49	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10'506	20.2	0.3	1.9
DAX - Germany	13'696	20.0	1.7	2.4
MSCI Italy	708	23.0	0.3	-9.1
IBEX - Spain	8'149	35.1	-0.9	-12.2
DJ Euro Stoxx 50 - Eurozone	3'566	23.1	0.4	-2.9
MSCI UK	1'844	21.7	0.0	-11.6
S&P 500 - USA	3'701	26.2	0.8	16.6
Nasdaq 100 - USA	12'668	32.7	2.5	46.3
MSCI Emerging Markets	1'264	19.6	0.6	15.9

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.88	6.9	-0.4	-9.0
EUR-CHF	1.08	4.5	0.3	-0.6
GBP-CHF	1.20	8.9	1.8	-5.7
EUR-USD	1.22	7.0	0.8	9.2
GBP-USD	1.36	9.5	2.2	3.6
USD-JPY	103.1	6.7	-1.1	-5.3
EUR-GBP	0.90	8.4	-1.4	5.4
EUR-SEK	10.17	6.2	-0.8	-2.9
EUR-NOK	10.50	8.6	-1.4	6.4

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	77	9.1	3.9	-5.9
Brent crude oil - USD / barrel	51	30.9	4.9	-23.8
Gold bullion - USD / Troy ounce	1'878	20.6	2.1	24.0

Source: J. Safra Sarasin, Bloomberg as of 17.12.2020



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Cross-Asset Weekly

17 December 2020



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