Andrew Hunt Economics Ltd. 8th February 2019

Global Weekly Review

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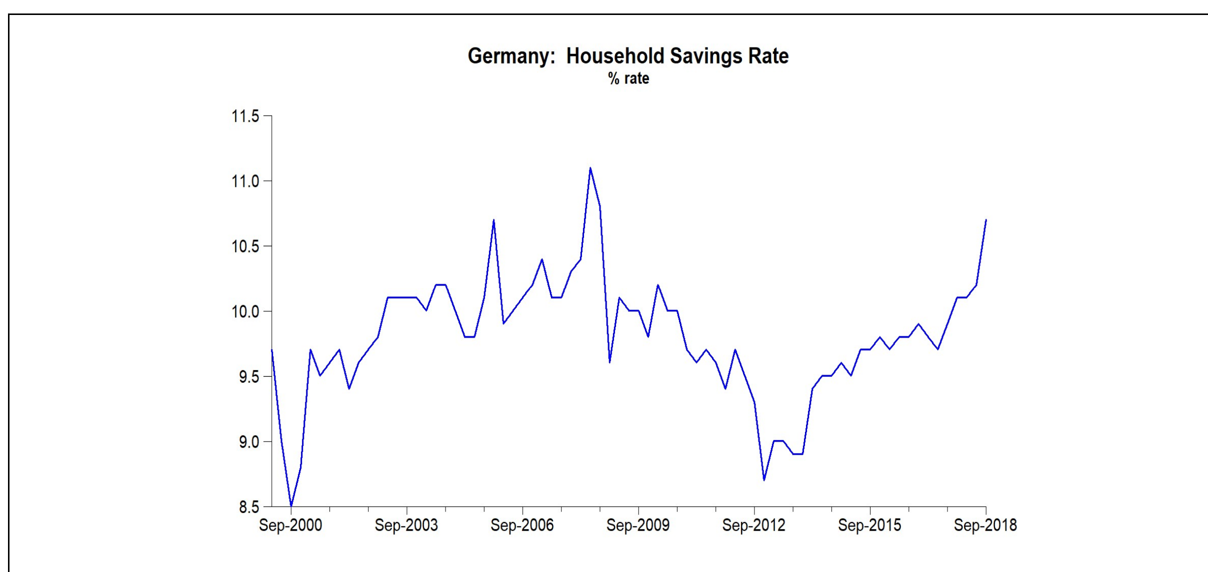
Commentary Drawn to Europe

There can be no doubt that consensus expectations with regard to Europe and in particular for growth in the Euro Zone have changed immensely over recent weeks. Towards the end of 2018, and even during early January, our sub-trend growth forecast for the EZ (primarily in response to weaker word trade trends – see BD191) was frequently greeted with polite scepticism but a little more than a month later the weak EZ view seems a remarkably consensus position and we mentally have to remind ourselves not to participate in some form of race to the bottom with our forecasts. That being said, we are finding ourselves drawn in our analysis to events in the EZ, just as last year in was global finance / the EM that exerted a pull on our 'investor landmine detecting' tendencies.

It seems to us that there are perhaps half a dozen key questions facing the Euro Zone in 2019. Firstly, and most obviously, there is the matter of the ongoing world trade slowdown (which could yet include expand to include the impact of a hard BREXIT) and its likely impact not only on export trends but also on domestic income trends (since exports provide a boost to domestic incomes as well as production). Secondly, there is the (in our view) grossly under-reported issue of Northwest Europe's rising household savings rates and the potentially highly deflationary impulses that they imply. Indeed, we suspect that the increase in the German savings rate represents a similar threat to the Euro as did German Reunification to the ERM System.



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Thirdly, there is the re-emergence of deflationary pressures within Italy (now that the camouflage of booming world trade trends has been lifted). Fourthly there is the 'hangover' that may develop as a result of France's 2017-18 credit excesses, a hangover that may yet envelop it banks in a mini crisis.

Our fifth issues revolves around the ability of the Spanish economy to continue to outperform its peers (which we shall explore in a stand-alone review next week), while our final concern centres on just how the ECB will seek to reconcile the seemingly contradictory needs of the EZ's dwindling number of creditor states with those of the both debtor countries and the various national public sectors, while at the same time attempting to provide a stimulus to the Region (in response to a slowdown that it simply didn't see coming).

World Trade Head -or Cross - winds

We have long thought that in some respects economies are in a sense akin bicycles or even racing cars: if you go too fast they tend to crash but also if you go too slowly they can be difficult to turn and very susceptible to destabilizing headwinds and cross winds – even quite minor shocks can cause you to fall off a bike if you are going very slowly and it certainly seems to us that Europe's progress has been very pedestrian over the last decade.

Since 2010, *per capita* nominal GDP in the EZ has increased from EUR28k to around EUR33k today, an average growth rate of only circa 1.8% per annum (aggregate GDP growth has proceeded at around a 1.9% rate). These rates have clearly been pedestrian (i.e. roughly half that of the USA) but they have nevertheless generated an extra EUR2 trillion of GDP. This growth has allowed for the creation of around 6 million new jobs (a useful but unspectacular 4.5% increase), and a 22% increase (equivalent to EUR1 trillion) in nominal wage incomes over the period. Unfortunately, the EZ consumer price index has increased by 11% over the same period, thereby suggesting that average real wage growth has only been around 0.6-0.7% per annum since 2010.

These underwhelming results have occurred despite what might be described as having been an 'okay' global environment – other countries have clearly had their problems but US growth rates have been "acceptable", and China's emergence has clearly provided a major boost to not only global GDP but more particularly global trade trends since 2008 (even though this could soon subside). Although the growth rate of world trade has certainly been lower than it was in the 2000s – despite the PRC's influence - trade volumes have nevertheless expanded significantly over the 2010s and Europe will have benefited (as well as contributed) to this event. Clearly the EZ bicycle has not been moving very fast despite what have been reasonably useful international tailwinds for much of the last decade.

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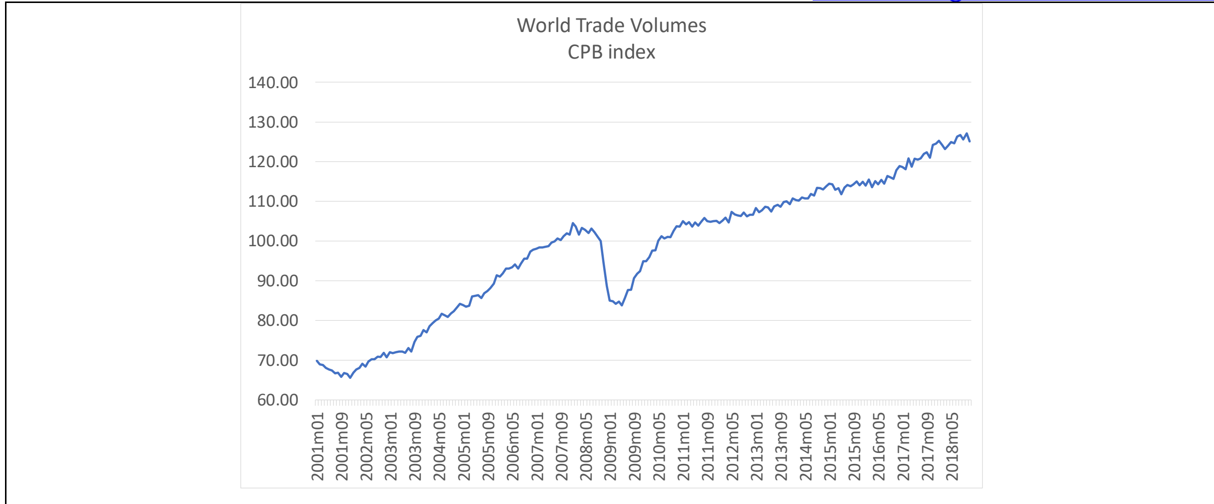
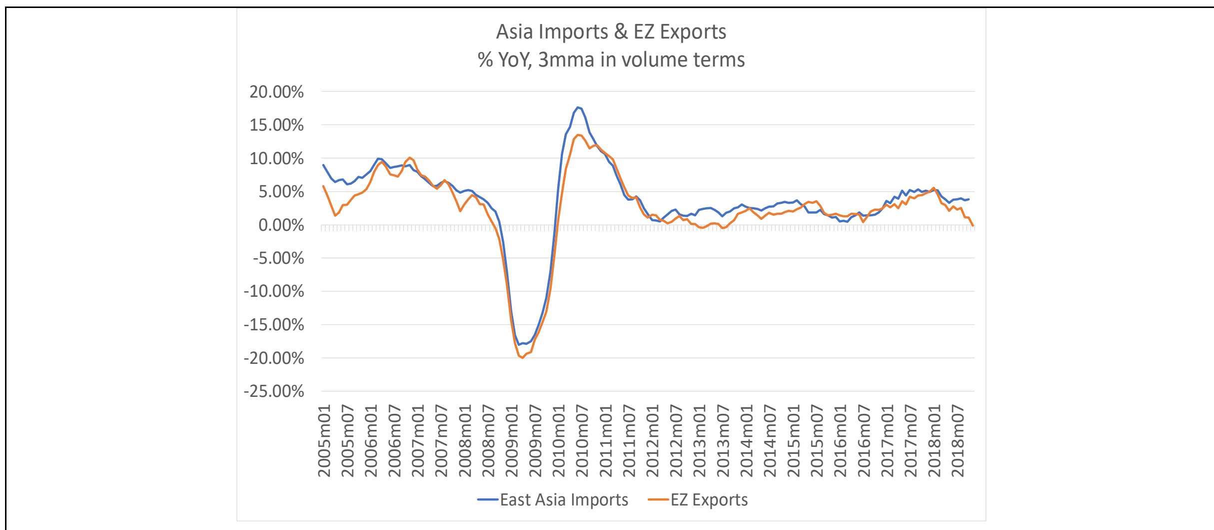


In fact, of the EUR2 trillion increase in the EZ's level of GDP, we calculate that fully EUR400 billion has come *directly* from the Region's expanded current account surplus. It is usually accepted that the 'multiplier' attached to trade is around 1.5-2.0 times, a situation that suggests that between a third and one half of the EZ's growth might have been attributable to its expanding external trade surplus. To continue our cycling analogy, it seems that the EZ's domestic economy has contributed relatively little to 'the bicycle's progress). However, global trade recessions typically exert a profound influence on EZ export trends, and we also note in this context that EZ *export* trends have come to lag Asian *import* trends by a month or two over the last 10 – 15 years. Given the recent rather sudden downturn in much of the Asian trade data, we suspect that the former trade tailwinds have recently become e a sufficiently strong headwind force a significant wobble in the EZ's economy.



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Since 2010, China's economy has raised its imports by almost EUR800 billion and in so doing it has reduced its current account surplus by EUR130 billion. Over the same period, the EZ current account surplus has increased by EUR350 billion and therefore we must wonder just how well the EZ's economies might have fared had the PRC not provided such a significant boost to global trade and clearly China's current cyclical slowdown – which could easily become rather more permanent if the PRC authorities are not careful – represents a particular challenge to the EZ region.

BREXIT: Beware a Deflationary Outcome

The UK economy possesses a current account deficit of around £80 billion, although some estimates would place it even higher. By far the largest component of the deficit occurs within the UK's trade with the EU and it would be our working hypothesis that, in the event of a "Hard BREXIT", the UK would struggle to gain sufficient capital inflows to cover its deficit (this is our 'baseline' scenario, although we also acknowledge that it is far from impossible that, following a BREXIT and given the problems within the EZ, capital account flows might remain strong and the UK therefore might not be required to adjust). If sufficient inflows of capital were not to forthcoming (i.e. the base scenario), then the UK economy would likely shrink its current account by perhaps a half in a relatively short space of time, either via a sharp decline in sterling or an intense contraction in domestic demand. Either (or both) events would impose a significant drag on the EZ economy of around 0.5% of EZ GDP in aggregate, although the effects would be felt disproportionately strongly in Germany & the Netherlands. Given the EZ's sensitivity to global trade trends, a hard BREXIT that resulted in a sharp contraction in the UK's current account deficit would certainly provide another significant headwind to the EZ bicycle and we could easily envisage such an event being sufficient to push the Region further into a recession.

The EZ's – and France's - Expensive Growth

Although as we have noted the EZ's GDP has only increased modestly since 2010 (and domestic demand by even less…), we find that over the same time period, the ECB's balance sheet has grown by EUR4.5 trillion; the level of public sector (on balance sheet) debt by EUR1.8 trillion; the level of private sector bank debt by EUR300 billion; and securitized private sector debt by a further EUR300 billion. Clearly, the 2010s have not been a period of de-leveraging within the EZ economy and it remains to be seen just how the authorities will deal with their debt burdens in the decades ahead as their populations age. The increase in both reported and contingent liabilities within the EZ public sectors appears particularly worrisome to us.

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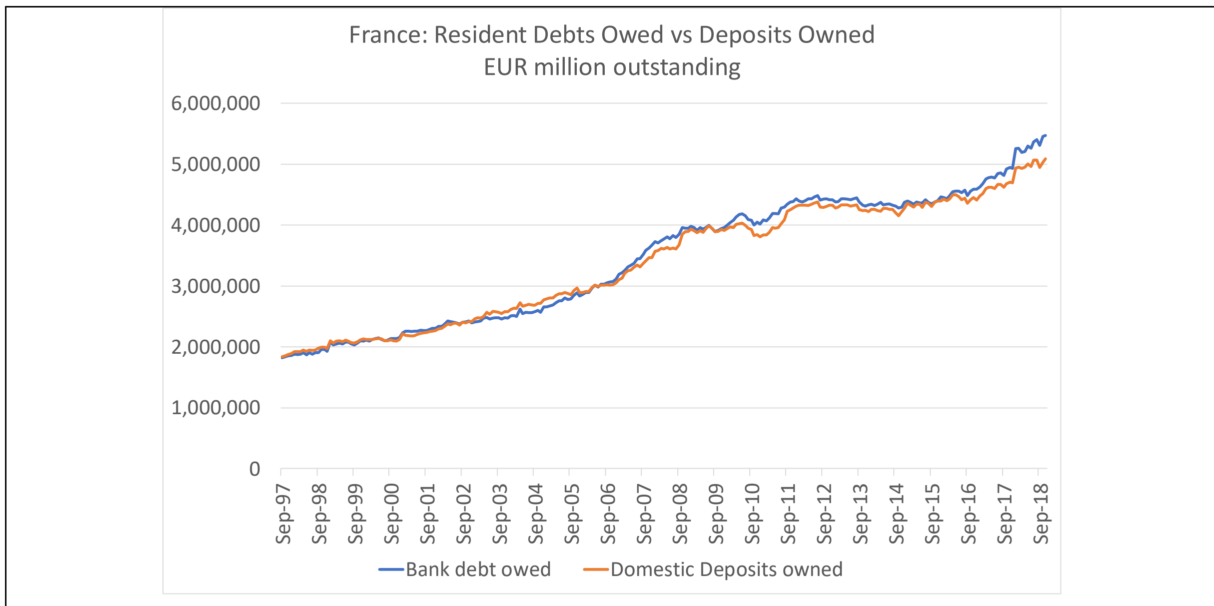
Interestingly, we can also observe that of the $300 billion of corporate bonds that have been issued in the EZ, fully EUR260 billion were issued by French corporations, while the volume of bank lending to French households has increased by EUR250 billion and to French corporations by EUR200 billion. France has clearly been one of the few hotspots within the Euro Zone's credit data, despite the country's persistently weak underlying balance of payments position. Clearly, the French economy has amassed a considerable further debt burden that will bring with it its own sustainability problems as the economy slows but, in a situation that is all too reminiscent of countless EM over the last thirty years, and Portugal in the early 2000s, we find that the French banks have utilized around EUR400 billion of foreign funding (chiefly USD) in order to support this growth.

The heavy use of foreign funding for the credit boom implies that, not only are the French banks 'short' of EUR billion of foreign currency, but also that France's private sector has incurred and extra EUR600 billion (or more…) of debt since 2010 but that it has only created EUR300 billion of new domestic liquidity that could be used to repay that debt…. The French banks, and indeed the wider private sector, are therefore facing a potential solvency crisis of the type that enveloped Portugal in the late 2000s.



Of course, and unlike the EM or even Portugal, it is simply unthinkable that the EU/ECB would ever allow such a crisis to fully evolve and hence it is our expectation that ultimately the ECB will create another EUR400 billion or more in credit to the French banks to ensure that France avoids such a crisis.

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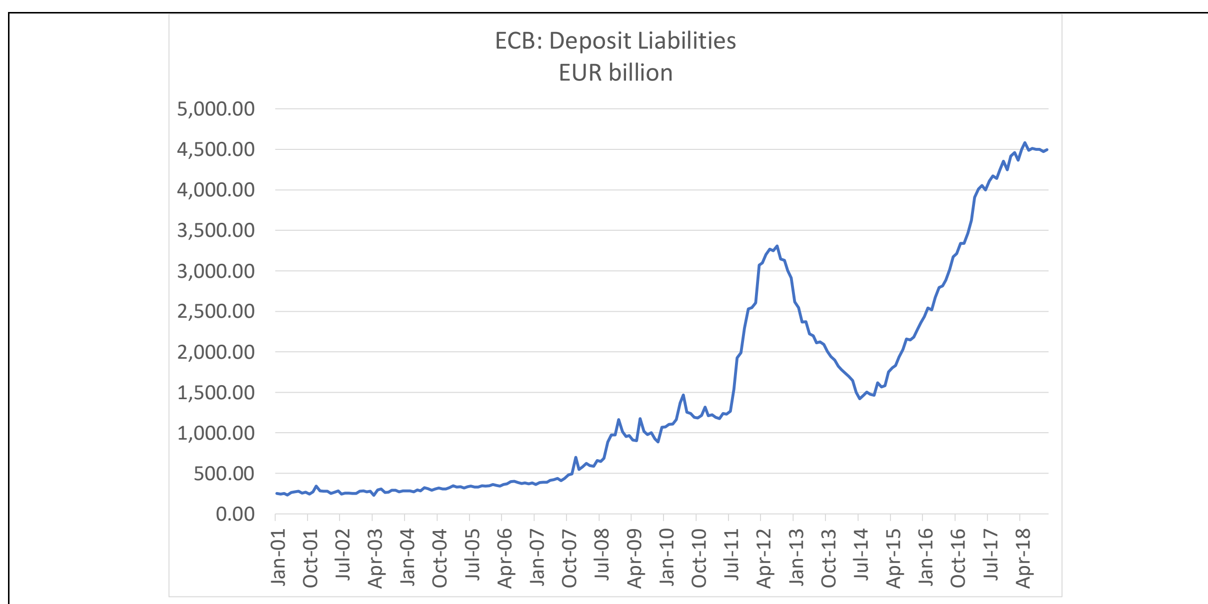
However, given Italy's and others' probable needs, this need to rescue France suggests that over the next 12 months the ECB's balance sheet will expand by another EUR1 trillion, or quite possibly more. In a zero-interest rate regime, there is a natural tendency to assume that the ECB providing another EUR1 trillion of credit through either LTROs or more opaquely through the TARGET2 system represents a costless 'rescue' but there is of course no such thing as a free lunch in economics……



Of the ECB's soon to be EUR8 trillion of liabilities, we estimate that EUR4 trillion will "pay" interest, in that they are the deposit holdings of the EZ private sector (primarily banks). However, in the 'Alice-in-Wonderland' world in which the ECB operates, these deposits pay a negative interest rate, which implies that it will cost the owners of these deposits EUR15 -20 billion for the pleasure of holding these deposits. In the context of an EZ banking system that currently only possesses (in theory) EUR2.7 trillion of capital (which it hasn't been able to expand since the ECB enacted its current rate regime), the costs of maintaining the ECB's balance sheet for its creditors are far from insignificant.

In fact, the situation in reality is even worse than these figures suggest in that, since Germany's banking system 'owns' three quarters of the reserves in the system, the charge on its already capital-depleted banks is particularly onerous. Indeed, we suspect that holding reserve deposits at the ECB will cost the German banks around 2-3% of their capital this year. This is clearly a very unhelpful situation for the German financial system and its savers in particular…..

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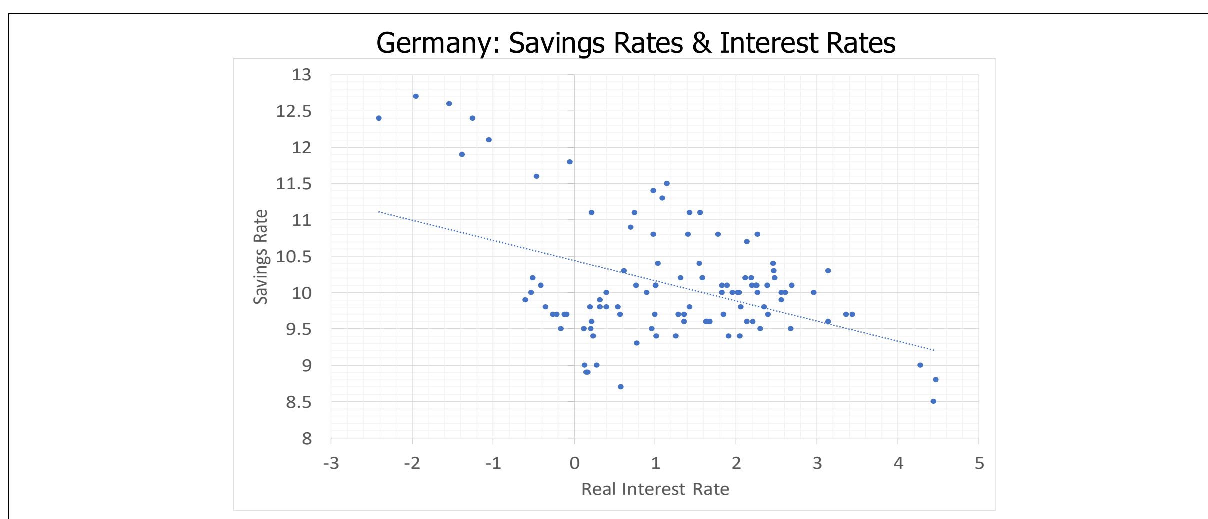
Catch 22 at the ECB

An obvious solution to this issue would be for the ECB to raise the deposit and repo rates so that the creditor banks at least earnt something when lending to the ECB/TARGET2. We further suspect that a move towards higher rates would encourage Northwest European savers to reduce their savings rates as it became 'easier' to achieve their target wealth levels, something that could well be to the *benefit* of domestic demand trends.



Unfortunately, positive rates would of course adversely impact the capital positions of the Region's debtor banks and perhaps more particularly the public sector's finances (governments have made heavy use of the ultra-low short-term interest rate regime for their own funding). Moreover, if the ECB were to move to a positive rate of interest for its liabilities, it would (most likely) instantly bankrupt itself, given the negative carry that it would then experience on many of its own recently acquired bond holdings (some of which were acquired at negative yields). Recapitalizing the ECB could easily cost EU (not just EZ!) governments 1% or more of regional GDP.

In summary, and to use another analogy, in order to save the French and Italian banking systems (amongst others), the ECB will in all likelihood need to expand its balance sheet by another EUR1 trillion (via loans rather than through further bond purchases) but if it does this it will implicitly be 'throwing the German and Dutch banks under the bus'. The only way to avoid the latter would be for the ECB to raise deposit rates but to do so would impair the Peripheral banks and most of all the public sector's own finances. Faced with so many contradictions, we can expect the member states to revert to type by focussing on their own narrow national interests. Indeed, we are already seeing clear signs of a lack of intra EZ harmony……

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Brussels' "Nuclear" Option

Rather worryingly, one possible escape route for the ECB / EU from this impasse that might seem attractive to its life-long public sector policymakers would be to adopt a more explicit version of Italy's solution to its bad bank problems. By simply bring the banks onto the public sector's balance sheet, in the short term at least many of the ECB's conflicting needs could be reconciled. As we note, this type of approach has already been adopted in the case of Italy's Carrige bank which has implicitly been placed firmly on the Finance Ministry's balance sheet (rather than placed into a resolution vehicle), although we must wonder just how much implicit state-aid a Deutsche-Commerzbank merger might involve…..

In practice, we do wonder if the EU is reaching a cross-roads in its own development. The EU elites' reactions to BREXIT and other events seem to have become ever less democratic (populist parties are portrayed as dangerous radicals that need to be controlled rather than learnt from despite the wishes of the electorates…) but if it were now to move towards the implicit nationalization of the financial system (which arguably has already begun when one looks at the size of the ECB's balance sheet..), then we might argue that the EU would be moving to a degree of undemocratic central planning and implied state control that not even Thatcher would have envisaged at her most strident.

It is not impossible that Europe's latest slowdown leads its leaders to push back against markets even more (we know that many in Brussels have never forgiven the markets for wrecking the ERM and they will not be about to take the same risk with their Euro Project).

ERM II and German Savings

Against such a background, it is perhaps not surprising to find that Germany's private sector – and indeed even its government have started to save harder so that they can 'weather' the uncertain environment ahead. However, if Germany as a nation is now determined to save more, then its current account surplus will by accounting definition endeavour to widen in the midst of a global trade slowdown that has served to limit its export growth. Clearly, the only way in which Germany will be able to achieve a wider current account surplus as it attempts to save more is if it (potentially savagely) reduces its imports. Naturally, a decline in German import demand will place further deflationary pressure through its trade accounts on its principle trading partners who are – of course – its EZ partners. We must wonder if the recent sharp decline in EZ intra-regional trade flows has been a reflection of Germany's desire to raise its savings rate.

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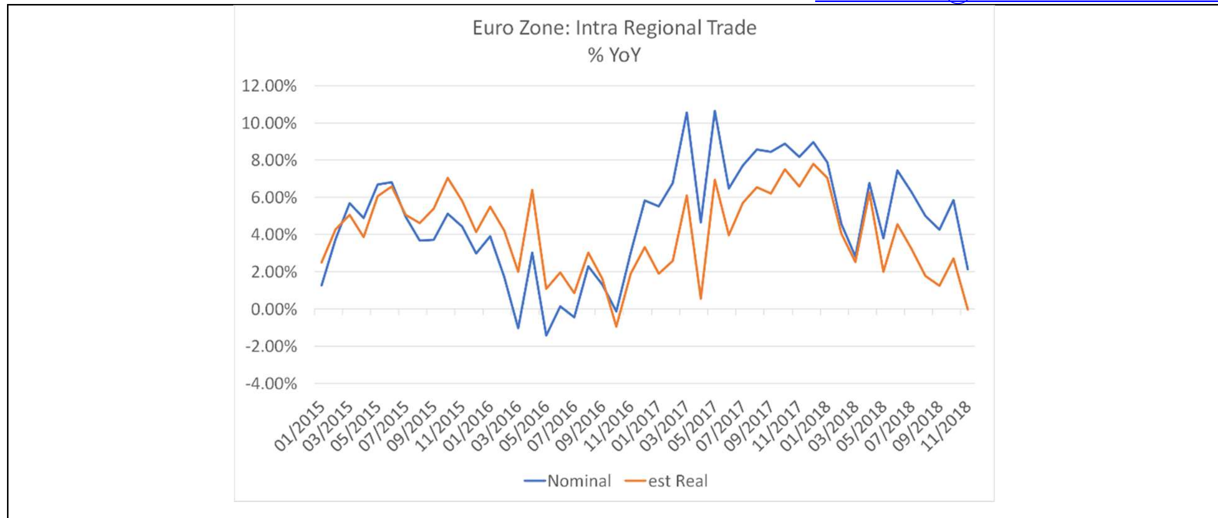
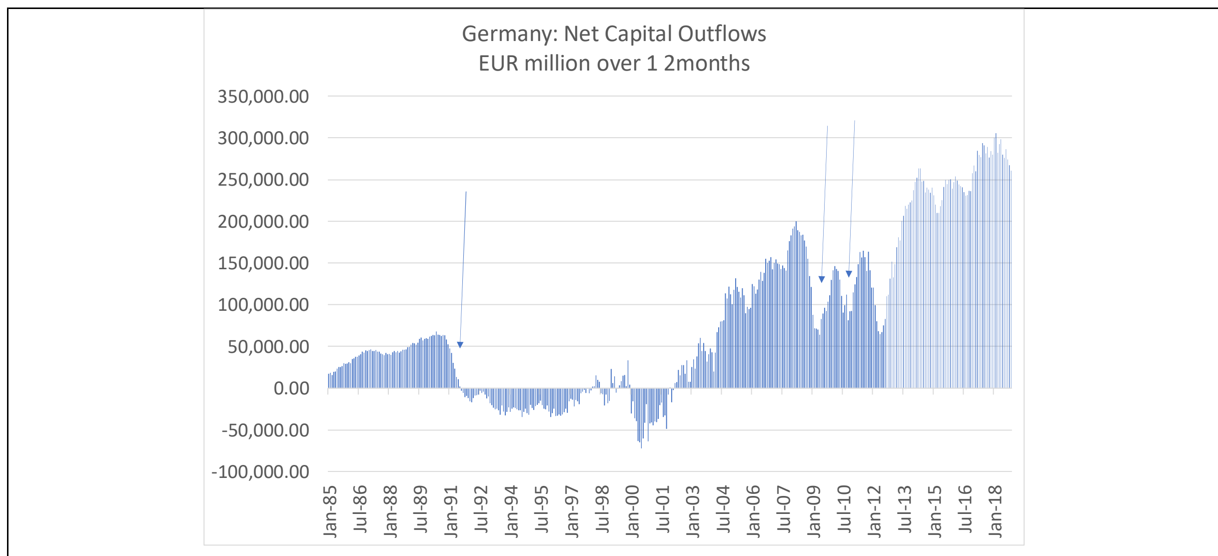


During 1990-1992, the demand of German reunification led Germany to absorb capital from its ERM fellow members and the result was to drive real interest rates higher across the currency bloc until the system fractured. In 2019, rising German savings could lead Germany to attempt to raise its trade surplus at the expense of its EZ partners.

Moreover, it is not impossible – indeed it is quite likely – that Germany's cautious savers might be less inclined to recycle their current account surplus into capital flows to their embattled Euro fellow members, thereby obliging the latter to suffer higher real interest rates. History suggests that when Germany seeks to absorb capital (either during its reunification in the early 1990s or when it experiences higher domestic savings (i.e. 2008-10), the results for the remainder of the currency bloc can be uncomfortable. In short, sudden internally-driven changes in Germany's domestic savings – investment balance can reverberate around the EZ Region.



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Conclusions

As we have compiled this piece, we have found ourselves wondering whether the 'half-way house' that is Europe (i.e. a currency union in what has never been an optimum currency area that has occurred without a political union) was in reality only made viable during the 2010s by China's emergence as a buoyant and very significant source of global demand.

We must wonder just how the EZ would have fared – and what the political consequences would have been – had China not raised its imports by $800 billion since 2010. Indeed, given that we suspect that the PRC was responsible for more than half of the increase in world trade that has occurred since the GFC – on which the EZ has been so reliant for its own growth, we wonder whether the EZ could have survived in its current form without China's growth?

However, now that China's growth has paused – possibly for some time – and world trade growth has subsided, the EZ faces a particular challenge at a time in which it is also struggling with its own internal conflicts and contradictions, which are of course typified by the Region's "problem" with interest rates.

Clearly, economic growth within the EZ is going to be very subdued or indeed absent over the next year and a Hard BREXIT could easily consign the EZ to a technical recession. Moreover, we also know that there is little in the way of conventional – or even unconventional – policies that Draghi and the ECB can do in response to this slowdown, aside from seek to achieve a weaker EUR exchange rate (and even that may be a difficult proposition vis-à-vis Mr Trump).

Instead, we believe that if the EZ is to avoid another existential crisis during the course of what looks set to be a deflationary slowdown, then the EU will likely have to extend the reach of the public sector still further through the explicit nationalization of parts of the financial system and we fear the further overriding of the democratically expressed wishes of national electorates. In practice, the latest economic slowdown will force the EZ to choose between *laissez faire* market-driven economics and politics, or something more centrally planned and less democratic.

The preferences of the professional Eurocrats in this regard are already plain to see but it will be interesting to see if the Region's creditors will acquiesce to such a major shift in the character of Europe.

As for the EUR itself, we suspect that it will face a number of headwinds in the form of weak growth and most of all the towering problem of the French banks' short USD positions (that could easily see it fall 5 – 10%) but whether it survives the situation intact will be a refection of how the EU is able to react to the challenges that this latest economic slowdown implies.

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