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The EU: The Haves and Have Nots

By Brian Fabbri

Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics

A bittersweet celebration

27 European nations met in Rome this past March to commemorate the anniversary of the founding of the European Union. Unfortunately they struggled to celebrate the 60th anniversary of the Treaty of Rome in spite of the tremendous success that the EU has achieved over the past six decades. Peace on the continent, a common market, a common currency, and multiple country expansion from the original six members, are some of the highlights from the past 60 years.

While the present members could soberly acknowledge that the Treaty bound the member nations together to avoid war among themselves and to create a mechanism to resolve internal EU disputes through diplomacy and with resolution for the common good, they also had to confront the reality that the EU has many potentially fatal flaws. Perhaps most evident is the emergence of populist parties, especially in founding member countries that are gaining political support throughout the EU and that fiercely oppose greater EU integration. Finally and most notably, is the abrupt exit of the UK, the EU's former 28th member and second largest economy.

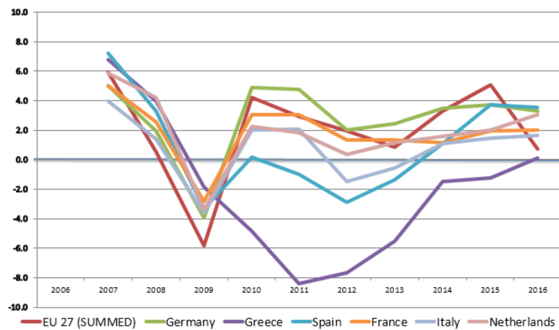
Perhaps the union is not mature enough to correct its gaping flaws, and that with more time it will heal its defects and live up to its heroic promise of democracy and closer economic union. But free trade, no tariffs and unrestricted migration of people have become the rallying cry of those political activists set against a greater common market.

Economic irony: countries that embraced conservative policies did better

Populists are deeply disturbed by the lost decade of economic growth and basically reject the conservative paradigm. They propose to the stalled economy, economic solutions that emphasize macro-policies that stimulate short-term economic growth and income redistribution, and deemphasize the

risks of inflation and public deficit finance. Ironically most of the EU has in fact followed these policies. The debt to GDP ratios of all Eurozone members rose from 65% in 2007 to a near unsustainable 90% by 2015, and yet economic growth in the EU stagnated. Greece and Italy are the two most outrageous examples of debt gone wild and nothing to show for it.

EU Little Real GDP annual growth in past decade



Interestingly, countries in the north and east of the EU such as, Poland and Sweden have avoided taking on more debt, or reduced their debt to GDP ratios. Ireland did and they have recorded the strongest GDP growth record among all EU economies since the recovery began.

Populist versus conservative policies are a sideshow

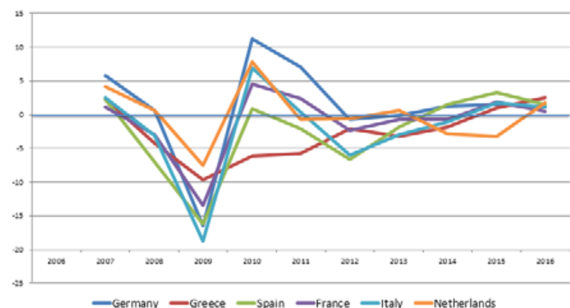
The outcome of the battle between proponents of populist economics and conservative economic policies, however, will not solve the core economic problems of the EU. These policy choices are a mere sideshow to the pressing long-term structural growth problems that will constrain economic expansion in the EU far into the future.

Instead of constant debate over the size of fiscal budgets, EU leaders should be devoting their attention to deregulating labor markets, expanding vocational training, and supporting apprenticeship programs to improve their labor markets. The UK and Germany did, and these 2 countries are presently enjoying 5% unemployment rates. It is a widely-accepted tenet among prominent economists that less regulation will improve competition, and stimulate entrepreneurship and innovation.

The economy: better for some than others

The EU economy has been a laggard among the major economic regions of the world. The EU took the longest to recover from the world economic recession in 2009. It has managed to grow real GDP by a meager 1.1% on average from 2010 to 2016.

EU: Miniscule Growth in industrial Production



Despite all the political noise within the Eurozone over widespread joblessness, the

EU economic recovery appears to be approaching lift-off. Economic activity appeared to have picked up some strength in the final months of 2016 on the back of solid domestic conditions. Recent high frequency economic data suggests that this momentum has carried over into early 2017. For example economic sentiment reached a nearly six-year high in February, and the composite PMI also hit the highest level in almost six years in March. Consequently, EU GDP growth is forecast to rise by 0.5% from the previous quarter in Q1, up from Q4's 0.4% expansion.

The economic forecast for 2017 made by an average of independent and government sources implies that real GDP in the Euro zone will increase by a consensus 1.6% in 2017, and 1.7% in 2018. While nothing to cheer about, it does represent progress. Finally, the long lags from a prolonged period of extremely accommodative monetary policy are bearing fruit.

An improving labor market and ultra-easy monetary policy should support faster growth in the domestic sector, and a pick-up in global economic activity will boost the external sector. However, rising inflation will take some wind out of consumption. Thus forecast EU GDP growth will come in a notch below 2016's 1.7%.

Greece, the EU's basket case, still needs EU financial support. It's growth prospects are no where to be seen. It is a constant reminder that not all boats float up with the incoming tide. In contrast, Spain, the other country in the EU with extremely high unemployment, has begun to exhibit some progress. Spain's economic growth is projected to rise above 2%, which should help to alleviate some of its appalling unemployment problems.

Inflation returning to target

Harmonized inflation came in at 2% in February, above January's 1.8% and marking the highest reading since January 2013. Higher energy prices have caused inflation to rise up to the European Central Bank's target of close to, but below, 2% for the first time in years. Rising price pressures led the ECB to strike a less dovish tone at its March monetary policy meeting, although it made no change to its policy stance.

No Inflation in EU until this year
(CPI annual change)

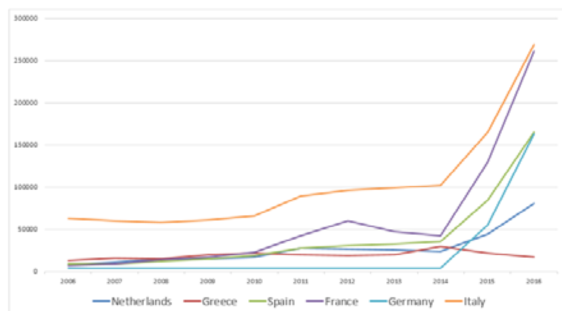
The consensus forecast now foresees inflation of 1.6% this year, after a puny 0.2% in 2016. Higher inflation will be driven by the diminished impact of low energy prices and reduced economic slack. In 2018, inflation is seen holding broadly steady at 1.5%.

The beginning of the end of super-easy monetary policy

The firmer economic momentum and rising inflation will probably cause the ECB to announce a tapering of its bond-buying program later this year.

The ECB has been unprecedentedly accommodative over the past several years. The ECB borrowed a famous mantra from the US Federal Reserve 'we will do whatever it takes'. And, It did. As the chart below shows, the ECB began purchasing sovereign bond debt from its member countries at a spectacular pace starting in 2014. At the same time it has maintained a near zero lending rate to member banks. After a long period of time these super-easy monetary policies, it appears to have begun to stimulate more economic growth, and with the help of rising oil prices, near target inflation.

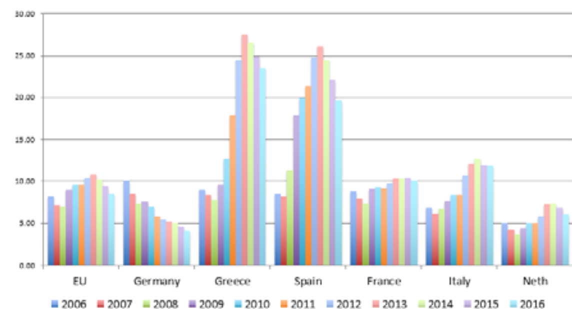
ECB holdings of EU sovereign bonds
Soaring



Where is the populist pressure coming from?

First and foremost is the unnaturally high unemployment rate that has persisted since the great recession in most EU member countries, especially those in the southern territory. As the next chart reveals, unemployment across the EU has only fallen slightly below 10% in the past year. And, it remains over 10% in nearly all of the founding EU member countries. Only in Germany has the unemployment dropped down to politically-tolerable levels below 5%.

EU Unemployment rate evolution
Remains high

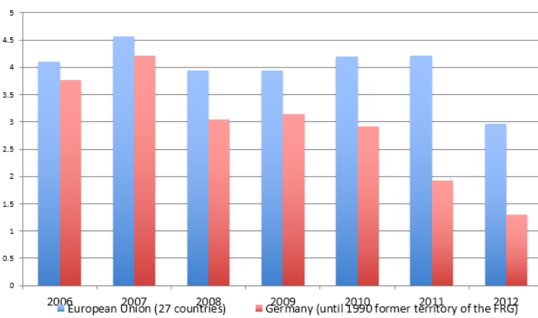


These chronic high unemployment concerns were exacerbated by the wave of immigrants that flowed throughout southern European countries in the past two years. Not only did the immigrants need fiscal relief, but they also would eventually compete with the indigenous populations for relative scarce jobs. This has created a public outcry that has fostered the development and growth of socially-diverse candidates for political leadership roles in several major member countries, where elections will be held in the next several months. Several of the derisive political

campaigners declare that if they were elected, and if they were able and willing to carry out their campaign promises, they would weaken, if not cripple, the foundations of the EU.

To some extent the profound weakness of the Euro over the past year or two, and its failure to rally in the midst of recent improving economic data, reflects these election uncertainties.

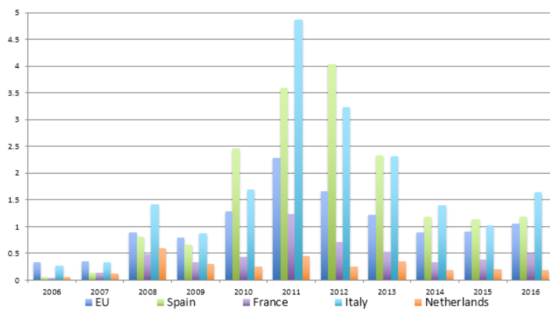
Yields on 10 yr. Bunds Lower than on EU bonds



Global Investors prefer Bunds

Another market-related symptom of global fears concerning EU fragility is the increased preference for German Bunds over sovereign Euro debentures. Of course, global investors always preferred Bunds. However, in the past two years, the spread paid by other sovereign borrowers over German Bunds widened significantly. Like the depreciating Euro, higher interest costs reveal heightened investor fears that the EU could break apart. If so, Germany's stellar conservative fiscal practices would draw even more international investment relative to all other European sovereigns.

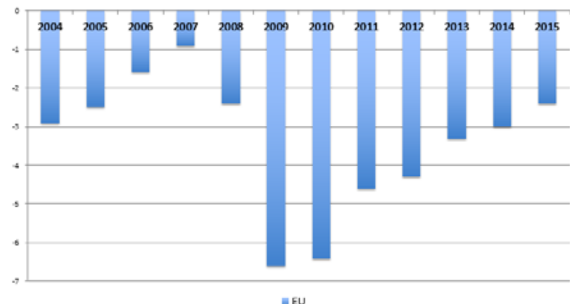
Yield spreads to German 10 yr. bunds are widening again



Budget deficits shrinking

The preference for Bunds diminished in the years following the EU's fiscal meltdown during 2012 and 2013. The ECB, the International Monetary Fund, and EU ministers in Brussels capitulated and funded Greece, stepped up purchases of sovereign bonds from Spain and Italy, and lowered interest rates sufficiently to liquefy troubled banks from the southern EU countries.

EU harmonized budget relative to GDP brought to target



With the imminent threat of national bankruptcies averted, and with old-fashioned tight fiscal policies adhered to by

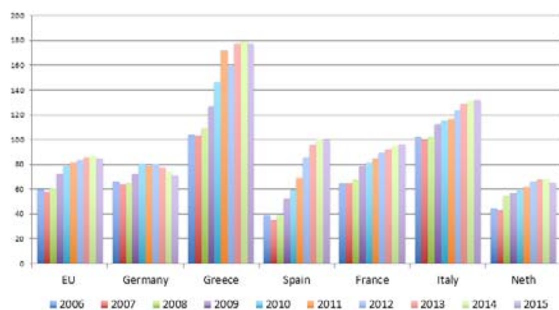
nearly all EU countries, investor confidence has returned. Consequently, the interest rate spreads of most EU country sovereign debt over Bunds have diminished.

Moreover, the EU harmonized budget balances relative to GDP improved. In 2015, the EU harmonized average actually fell below the targeted level of -3% of GDP.

Smaller budget deficits and higher debt to GDP bear a social cost

While enhanced investor confidence was a boon for debt issuers and did increase the volume of outstanding debt issued during the past several years. The enormous increase in sovereign debt issuance has steadily crept higher throughout the EU, and as a result, no country in the EU has a debt to GDP ratio below the EU standard of 60%. Ironically, steadily tighter fiscal policy hobbled EU economic growth.

Debt to GDP Ratio Rose everywhere



Conclusion: What's next for the EU

With provocations growing, both externally and internally, the EU needs to address their multitude of problems, if they are to survive another 60 years. For years, the EU leadership in Brussels has adopted the non-activist strategy of 'muddling through'. This unattractive policy may not be enough this time. The most prominent alternative to 'muddling through' is greater concentration of political power in the center, Brussels. A tighter union, however, is rallied against by all of the political parties arguing against the present union. They want less power flowing to the center and greater autonomy. With popular opposition growing the centralist parties in the EU can only half-heartedly fight against this rising political tide.

Individualism versus solidarity

The initial EU idea of solidarity and sticking together through challenging times is being scuttled in favor of a more individualistic and nationalistic society. The most obvious demonstration of the rise in individualism will surface during the EU negotiations with the UK over the terms of Brexit. One key issue is that not all members of the EU share trade with the UK equally. For example, smaller EU member countries have a much larger percentage of their GDP in trade with the UK than larger countries. Consequently, they will suffer more and negotiate differently than the big members will. Moreover, there are important differences of interest among member countries. For example, some countries are dependent on key industries for their trade with the UK. Therefore, it will be hard to reconcile these different individual country needs within the

general framework of bargaining with the UK. These differences in interests will be a challenging test for EU solidarity in their upcoming negotiations with the UK.

Something new: flexibility

Consequently, something new needs to be tried, such as a more flexible union. *Multi-speed* or *multi-tier* EU concepts have been floated around EU circles in the past, but after Brexit, they have recently gained significant gravitas. The concept is that core EU countries, i.e., those that share the single currency, need more integration and shared institutions such as a proper banking union and a common debt instrument. The next tier would comprise a looser group of EU members that are not ready to accept the sacrifice of sovereignty needed to join the euro. In addition, a multi-tier Europe should accommodate widely differing countries, where they could choose the parts of the EU that they want, and avoid the rest.

Presumably, this new form of EU would have been sufficient to keep the UK in the EU, as the UK would have chosen the benefits of a common market, and contributed to common defense and security without having to accept open borders and the Euro. All would have benefitted.

Hopefully an improving economy will provide some time for EU leaders to adjust their past prejudices of 'one size fits all' and begin to accommodate the new reality of flexibility. Of course this assumes the populists fail at the upcoming polls.

For more information, please contact
camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 31 MARCH 2017)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2362.72	0.12%	0.12%	17.16%	17.16%	3MO LIBOR	1.15	82.88
FTSE	7322.92	1.12%	2.14%	23.39%	7.52%	10YR UST	2.39	34.98
NIKKEI	18909.26	-0.47%	0.09%	14.87%	16.09%	10YR BUND	0.33	114.94
HANG SENG	24111.59	1.69%	1.57%	20.56%	20.33%	10YR SPG	1.67	15.98
STI	3175.11	2.74%	2.91%	16.32%	12.18%	10YR SGS	2.25	22.21
EUR	1.07	0.72%		-6.40%		US ISM	57.20	10.64
YEN	111.39	-1.22%		-1.05%		EU PMI	56.20	8.91
CMCI	1150.34	-3.47%		19.22%		JP TANKAN	10.00	42.86
Oil	50.60	-6.31%		31.98%		CHINA IP	6.00	-11.76

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency

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