The EU Suffers Most from Known Risks

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The time clock is ticking for the EU

Political discord runs rampant throughout the EU. Brexit negotiation resolution is a Herculean hurdle for both EU and UK authorities. Complicated negotiations are threatening to bring down the UK government and any meaningful settlement with the EU is well out of sight. Brexit has also become a powerful precedent for other dissatisfied EU members in Spain, Italy Scotland, and now Poland and Hungry.

The EU is in political turmoil: Unrestrained and sympathetic immigration of African and Middle Eastern refugees has become a catalyst for many past grievances, and the springboard for populist parties to leap into power. Populist parties extoled beliefs run diametrically counter to those of the founding principles of the EU and threaten total disruption of the 27-member countries.

It’s not just economics

Most recently the EU has had to absorb and respond to the imposition of trade tariffs from the US, and to adjust to a contentious tirade by US President Donald Trump against their meager budgeted military expenditure. Such fractious warnings coincide with a more belligerent posture by Russia, especially at the EU’s Baltic borders. 2018 has been a difficult year for the EU.

2018 didn’t start bad

At the beginning of this year, economic savants were busily adjusting their forecasts for EU economic growth upward on the back of faster economic activity anticipated in the
US and rest of the world. GDP growth in the EU had snapped upward in 2017 brightening the outlook for the EU, after several years of disappointing sparse economic expansion.

Once President Trump began his tirade and tweetstorms against virtually all of US’ trading partners early this year, the fortunes of EU stocks, currency and GDP growth began to shrink. EU business uncertainty was already agitated by the negotiations with the UK over Brexit, and now it climbed higher over the uncertainty concerning an escalating tariff war with the US. Business intentions for capital investment were shattered, as the unknown outcome of tariffs defeated any serious business plan for expansion. Orders were canceled, and industrial activity shuddered.

As seen in the chart above, the PMI indexes for all major EU countries peaked in the 4th quarter of 2017 and dropped sharply since. Germany boasts the biggest economy in the EU, however, it is also the most external trade dependent and therefore it is the most vulnerable economy in the EU to the threats of a trade war with the US. German export growth has already started to decline, and this has led to the postponement of investment activity, at least until the uncertainty from tariff impositions clears. This is already evident in the recent decline in new orders for investment spending. It has been highlighted in the PMI for Germany, which fell 6% on a year-over-year basis ending in April.
It’s not just tariffs that have punished the EU economy

The recent jump in the price of oil is another debilitating punch to the energy-dependent EU economies. Oil prices have soared 61% in the past 12 months. The problem of rising oil prices is more damaging when looked at from the perspective of the Euro. The Euro has depreciated by 6% versus the dollar since the beginning of the year. Because oil is traded in dollars, the relevant cost of oil for EU economies is in dollars. As a consequence, EU energy costs have soared by 67%. And as a result of the EU being totally dependent upon imported oil, the heightened cost of energy will distort consumption patterns, raise inflation and reduce the EU’s net trade surplus.

It might also affect regional politics: it could draw the EU closer to Russia. Russia supplies most of the EU with natural gas. This energy alternative may also be perceived as more sustainable and efficient than relying on imported oil and its unpredictable price volatility. The price the EU might have to bear is closer political ties to Russia and the removal of the trade barriers that the EU erected along with the US to punish Russia for invading the Ukraine.

The Euro has been weakening

In keeping with the increasing uncertainties caused first by Brexit, and more recently by the tariff wars with the US, the Euro has depreciated for most of this year. From a trade perspective this is a natural and favorable economic response. It should provide some support to EU industries affected by the higher costs of rising tariffs. However, it will contribute to higher inflation.
Inflation is beckoning

Higher tariffs on imported items from the US, a depreciating currency and the lagged effects of ultra-accommodative monetary policy, have planted the seeds for growing inflation throughout the EU. Presently the monetary authorities (ECB) have indicated they will tolerate inflation creeping above their long-term inflation target of 2% per annum. Already (through May 2018) inflation year-over-year in the three largest economies in the EU (Germany, France and Spain) have climbed above 2%, with this measurement taken before the imposition of the tariffs on US imports. Spain is the most sensitive to higher inflation since oil accounts for a much greater share of its market basket than in other EU economies. Higher oil prices will also siphon funds away from other sources of consumption in Spain, making it the most vulnerable economy in the EU to higher energy costs. It is most certain that inflation will accelerate further in the EU and draw in the ECB to alter their accommodative monetary posture.

Central banks are gently tightening monetary policy

Central banks everywhere have begun to slowly reduce their aggressive monetary accommodation and to raise their official interest rates. Led by the Federal Reserve in the US that has raised rates 8 times in the past 36 months, has stopped its purchases of securities, and has begun to let some of its holdings gently roll off. It is quite natural for central banks to adjust their policies now in light of declining unemployment rates, more rapid GDP growth and accelerating inflation. Of course, the imposition of higher tariffs across the world’s economies and disruptions to existing global supply chains will boost inflation more than the traditional upward effects from the strengthening and prolonged business cycle. Consequently, central banks everywhere will have to accelerate the pace of the removal of their excessive recent monetary accommodation.
Bond yields remain low except for Italy

![Graph showing bond yields]

**Higher interest rates are coming**

It is inevitable that interest rates will rise in the EU and probably throughout the world. As is typical in an aging business cycle expansion inflation rises and with it interest rates will increase as well. Add to this inevitable effect a shift in monetary policy toward higher official rates, no further securities purchases, and a depreciating Euro, the confluence of factors strongly suggests that longer maturity debt instruments will have higher yields.

This is and will be particularly true for the high debt-to-GDP ratio economies, such as Italy and Spain. Already their sovereign bond yields are substantially higher than Germany’s. Moreover, the new coalition government in Italy has promised costly fiscal reforms and tax abatement. While they may cause a political imbroglio with the EU if these political promises materialize - because their promises will put Italy in violation of EU budget regulations - they will unavoidably cause investors to demand higher rates for Italy’s debt.

The Italian coalition’s fiscal plans also invite bond rating agencies to review Italy’s present rating status and place them on a downgrade trajectory.

Spain also has a very high debt-to-GDP ratio and they too are struggling with their budget. Moreover - and like Italy - Spain faces political upheaval and they could face new elections sooner than the present end of their current parliament in 2020. All this political uncertainty will add to investor demands for higher sovereign bond yields in Italy and Spain.

**Exit sign is approaching for the UK**

In less than one year, the UK must exit the EU according to the UK’s commitment. Unfortunately, there is no imminent sign of successful exit negotiation with the EU, and there is gathering political upheaval in the UK over the actual exit plan being proposed by the UK government. Yes, an extension could be agreed to, but that will not soothe the uncertainty confronting British and EU business investment plans. Presently EU companies are making plans to extract their operations from the UK and certainly are not planning on any new investments. UK’s withdrawal from the EU without a negotiated settlement creates a nightmare scenario for businesses given 50% of UK trade is with the EU. Even with a negotiated settlement, trade between the EU and UK will almost certainly be less than what it was, and without trying to estimate the winners
and losers, both will suffer wasted business and slower GDP growth.

At present the UK economy is touching full employment and this is provoking the Bank of England to seek higher official interest rates and tighter monetary policy. Higher interest rates are also inevitable because the pound continues to depreciate against the dollar and the Euro. Such monetary policy, on top of weakening demand and sub-par GDP growth, will create more tension for the government in their quest for an agreeable negotiation. This is a recipe for political confrontation in the UK and greater business risk aversion everywhere.

**Conclusion: risk is back and rising rapidly**

These are the known risks:

- Immigration issues are tearing the EU political fabric and boosting support for populist anti-EU political parties into prominence.
- The Brexit process is more uncertain than ever with no settlement in sight. It is a lose-lose scenario for both economies.
- Higher tariffs from the US threaten EU’s GDP growth, create rising inflation, and provoke tighter monetary policy.
- The new US tax policy, which reduced corporate taxes, has caused US firms to repatriate billions of dollar profits from the EU at a record-setting pace.
- Uncertainties in the EU due to tariffs and Brexit have prevented US firms from reinvesting profits back into EU businesses.
- Rising tensions within NATO amid demands by the US for the EU to spend more for defense than they have been, risks more budget disruptions to their fiscal priorities and it will probably cause interest rates to spike.
- At present the EU cannot afford more government spending to meet its commitment for defense (2% of GDP at a minimum) and after years of relying on the US to provide security the EU finds itself without the capability to defend itself.

The unknown risks, and as long as everyone doesn’t get along, pose potentially even bigger economic threats and more lethal political instability for the EU.

*For more information, please contact camri@nus.edu.sg*
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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 (CMCPI)

**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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